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The Repeal of the Thirty Percent Withholding Tax on Portfolio Interest Paid to Foreign Investors*

I. INTRODUCTION

The Eurobond market is currently one of the most attractive sources of debt financing for the medium and long-term capital needs of United States corporations, the federal government and governmental agencies. Congress significantly broadened and statutorily ensured direct access to this market in its enactment of Section 127 of the Deficit Reduction Act of 1984 (the 1984 Act), which repealed the thirty percent withholding tax on "portfolio interest" paid to foreign investors.¹ Thus, in 1984

* This paper reflects developments through October 15, 1985.

The author would like to thank L.G. Harter III, Esq. of Baker & McKenzie, for his critique of this Comment. Errors, however, remain the sole responsibility of the author.

All citations to the Internal Revenue Code refer to the 1985 version of the Code, unless otherwise stated.

¹ Section 127(a) of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 648 (1984) [hereinafter cited as the 1984 Act] amended I.R.C. Sec. 871 (1983) (Tax on Nonresident Alien Individuals) by adding the following new subsection:

(h) REPEAL OF TAX ON INTEREST OF NONRESIDENT ALIEN INDIVIDUALS RECEIVED FROM CERTAIN PORTFOLIO DEBT INVESTMENTS.—

(1) IN GENERAL.—In the case of any portfolio interest received by a nonresident individual from sources within the United States, no tax shall be imposed under paragraph (1)(A) or (1)(C) of subsection (a).

(2) PORTFOLIO INTEREST.—For purposes of this subsection, the term "portfolio interest" means any interest (including original issue discount) which is described in any of the following subparagraphs:

(A) Certain Obligations Which Are Not Registered.—Interest which is paid on any obligation which—

(i) is not in registered form, and
(ii) is described in section 163(f)(2)(B).

(B) Certain Registered Obligations.—Interest which is paid on an obligation—

(i) which is in registered form, and
(ii) with respect to which the United States person who would otherwise be required to deduct and withhold tax from such interest under section 1441(a) has received a statement (which meets the requirements of paragraph (4)) that the beneficial owner of the obligation is not a United States person.

(3) PORTFOLIO INTEREST NOT TO INCLUDE INTEREST RECEIVED BY 10-PERCENT SHAREHOLDERS.—

For purpose of this subsection—

(A) In General.—The term "portfolio interest" shall not include any interest described in subparagraph (A) or (B) of paragraph (2) which is received by a 10-percent shareholder.

(B) 10-Percent Shareholder.—The term "10-percent shareholder" means—

alone, United States borrowers were able to raise over \$21 billion in the Eurobond market,² generally at interest rates lower than those available in the domestic market.³ The 1984 volume represents a significant and

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- (i) in the case of an obligation issued by a corporation, any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote, or
 - (ii) in the case of an obligation issued by a partnership, any person who owns 10 percent or more of the capital or profits interest in such partnership.

(C) Attribution Rules.—For purposes of determining ownership of stock under subparagraph (B)(i) the rules of section 318(a) shall apply, except that—

- (i) Section 318(a)(2)(C) shall be applied without regard to the 50-percent limitation therein, and,
- (ii) any stock which a person is treated as owning after application of section 318(a)(4) shall not, for purposes of applying paragraphs (2) and (3) of section 318(a), be treated as actually owned by such person.

Under regulations prescribed by the Secretary, rules similar to the rules of the preceding sentence shall be applied in determining the ownership of the capital or profits interest in a partnership for purposes of subparagraph (B)(ii).

(4) CERTAIN STATEMENTS.—A statement with respect to any obligation meets the requirements of this paragraph if such statement is made by—

(A) the beneficial owner of such obligation, or

(B) a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business.

The preceding sentence shall not apply to any statement with respect to payment of interest on any obligation by any person if, at least one month before such payment, the Secretary has published a determination that any statement from such person (or any class including such person) does not meet the requirements of this paragraph.

(5) SECRETARY MAY PROVIDE SUBSECTION NOT TO APPLY IN CASES OF INADEQUATE INFORMATION EXCHANGE.—

(A) In General.—If the Secretary determines that the exchange of information between the United States and a foreign country is inadequate to prevent evasion of the United States income tax by United States persons, the Secretary may provide in writing (and publish a statement) that the provisions of this subsection shall not apply to payments of interest to any person within such foreign country (or payments addressed to, or for the account of, persons within such foreign country) during the period—

- (i) beginning on the date specified by the Secretary, and
- (ii) ending on the date that the Secretary determines that the exchange of information between the United States and the foreign country is adequate to prevent the evasion of United States income tax by United States persons.

(B) Exception for Certain Obligations.—Subparagraph (A) shall not apply to the payment of interest on any obligation which is issued on, or before the date of the publication of the Secretary's determination under such subparagraph.

(6) REGISTERED FORM.—For purposes of this subsection, the term "registered form" has the same meaning given such term by section 163(f).

Section 127(b) of the Act amended I.R.C. § 881 (1983) (Tax on Income of Foreign Corporations Not Connected with United States Business) in a similar fashion.

Section 127(g) of the Act provided that the amendments made therein would apply to interest received after July 18, 1984, on obligations issued after that date.

² U.S. companies raised \$18.6 billion, making them the largest single borrower in the Eurobond market; the federal government and two federally-sponsored agencies raised \$2.5 billion. Total borrowings in the 1984 Eurobond market were \$81.5 billion. Wall St. J., Jan. 2, 1985, at 16, col. 2. Total borrowings in the Eurobond market for the first half of 1985 were \$66 billion; the volume for 1985 is pegged at \$130 billion. The Washington Post, Jul. 14, 1985, at H-6, col. 1.

³ According to the most recently-available statistics, cost savings in the 1983 Eurobond Market were as high as 119 basis points. Presentation of the Securities Industry Association before the U.S. Senate Committee on Finance, reprinted in *Tax Treatment of Interest Paid to Foreign Persons: Hearings before the Committee on Ways & Means on H.R. 3025 & H.R. 4029*, 98th Cong., 2d Sess. 89-90

favorable increase over 1983 United States corporate Eurobond issuances of only \$5.2 billion.⁴

The Eurobond market consists of an informal network of underwriters and investors which enables issuers in most countries to offer their debt securities to investors located outside the issuer's country of residence. In the Eurobond market, payments of principal and interest are typically made without any deduction for taxes which might be imposed by the government of the issuer's country of residence.

The general scheme of taxation of foreign investors under the United States Internal Revenue Code, however, generally requires that a thirty percent tax be withheld by a United States payor on interest income paid to foreign investors. Therefore, in order for United States corporations to compete effectively in the Eurobond market prior to the repeal legislation, they had to resort to the use of an "international finance subsidiary" located in a tax haven jurisdiction. By interposing this finance subsidiary (and qualifying under various United States tax laws and treaties), these corporations were able to avoid the United States withholding tax. This was the state of affairs until July of 1984, when the repeal legislation was enacted. In essence, the 1984 Act allows United States corporations to issue debt obligations directly to foreign investors, without having to utilize international finance subsidiaries.

The repeal legislation,⁵ a product of many years of lobbying by the securities industry, United States companies and the Treasury, represents congressional awareness and approval of the importance of foreign capital to the United States economy.⁶ The legislation, however, also reflects

(1984) Serial 98-84 [hereinafter cited as *May 1, 1984 Hearings*]. Latest reports of securities dealers indicate, however, that some narrowing in yields has occurred. This has been due, in large part, to the arrival of the U.S. Treasury into the Eurobond market. Cooper, *Second Thoughts about Eurobonds*, 19 INSTITUTIONAL INVESTOR 157 (1985). Even now, though, savings of 10 to 125 basis points are being achieved. The Washington Post, Jul. 14, 1985, at H-6, col. 1.

⁴ Wall St. J., Jan. 2, 1985, at 16, col. 2.

⁵ Articles on the 1984 repeal legislation include: Feingold & Fishman, *The DRA's Elimination of the "Withholding" Tax on Portfolio Interest*, 62 J. TAX'N 170 (1985); Granwell, *Repeal of the U.S. Withholding Tax on Interest*, 1 STRATEGY IN INT'L TAX 35 (1984) [hereinafter cited as *Repeal of the Withholding Tax*]; Granwell, *Repeal of the 30% Withholding Tax on Interest Paid to Foreigners*, 13 TAX MGMT INT'L J. (BNA) 306 (1984); Khokhar, *The 30 Percent U.S. Withholding Tax on Portfolio Interest Repealed*, 984 TAX MGMT. (BNA) A-501 (1984); Segal & Davis, *Repeal of the 30% Withholding Tax on Portfolio Interest*, 11 INT'L TAX J. 125 (1985); Shoyer, *Tax Treatment of Interest Paid to Foreign Investors-Policy and Practice Concerns*, 11 INT'L TAX J. 283 (1985); Recent Development, *Repeal of the Thirty Percent Withholding Tax on Interest Paid to Foreigners*, 26 HARV. INT'L L.J. 303 (1985). Articles on prior legislative attempts to repeal the withholding tax include Green, *Proposed Legislation Would Exempt Qualified Interest Payments From U.S. Withholding Taxes*, 10 INT'L TAX J. 189 (1984); New York State Bar Ass'n Tax Section, *The Withholding of Tax on Interest Paid by U.S. Borrowers to Foreign Lenders*, 6 INT'L TAX J. 126 (1979).

⁶ STAFF OF THE JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLA-

congressional fears of increased tax evasion by United States persons,⁷ a prediction frequently made by some members of Congress and by certain consumer and labor organizations who opposed the measure. As a result, Congress has attempted to balance the often-opposing interests of these groups, as well as those of the American public. In this regard, the repeal legislation can be viewed as "a microcosm of the workings of socioeconomics, politics and the tax law."⁸

The passage of the 1984 Act appeared initially to be a solution to what had become a complicated and theoretically unsound method of avoiding the thirty percent withholding tax on interest paid to foreign investors. Subsequent developments, however, including the issuance of now hotly-contested Treasury Regulations,⁹ the entry of the United States government into the Eurobond market,¹⁰ and the emergence of stiff competition among London and United States underwriters¹¹ indicates that the 1984 Act may have been only the beginning of the increasing debate over the repeal legislation.

The first part of this comment will examine the taxation of foreign investors and the operation of the Eurobond market prior to the 1984 Act, as well as the events which prompted the passage of the repeal legislation. The second part will explain the provisions of the new legislation and the treasury regulations implementing those provisions. It will also discuss the implications of two recently-issued revenue rulings on the use of tax havens, the practice of treaty shopping, and the effects of these rulings on existing Eurobond issues. The third part will address the policy arguments advanced in support of, and in opposition to, the repeal legislation. Finally, the fourth part will summarize the likely effects of the repeal legislation, concluding that, overall, the measure will be beneficial to the United States' economy over the long-term.

NATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 391-92 (Comm. Print Dec. 1984). JCS-41-84 [hereinafter cited as EXPLANATION OF THE 1984 ACT].

⁷ *Id.* at 393.

⁸ Segal & Davis, *supra* note 5, at 125.

⁹ See *infra* notes 107-24 and accompanying text.

¹⁰ See *infra* notes 93-99 and accompanying text.

¹¹ Such competition has resulted in losses to brokers in London's Eurohouses. Glynne, *The Big Eurobond Brawl*, 19 INSTITUTIONAL INVESTOR 277 (1985).

II. AN OVERVIEW OF UNITED STATES TAXATION OF INTEREST PAID TO FOREIGN INVESTORS IN THE EUROBOND MARKET PRIOR TO THE 1984 ACT

A. *Taxation of Foreign Investors—In General*

Foreign investors (*i.e.*, nonresident aliens and foreign corporations) may earn income in the United States in a variety of ways: employment, direct ownership of businesses or real estate in the United States, and ownership of intangible United States assets, such as stocks and bonds.¹² To the extent that the investor is a resident of the United States or derives income from the active conduct of a trade or business in the United States, the resulting income will be taxed in the same manner that such income is taxed to United States citizens (*i.e.*, at regular graduated rates).¹³ Passive income from investments in United States assets such as interest and dividends is, however, notwithstanding the repeal on "portfolio interest," generally subject to a flat thirty percent tax¹⁴ which is withheld at the source of payment.¹⁵

B. *The Eurobond Market and Finance Subsidiaries*

The existence of the withholding tax on interest income has historically influenced the manner in which foreigners have invested in United States assets and, consequently, the manner in which United States busi-

¹² For details on the Internal Revenue Code's treatment of foreign investors, see generally P. POSTLEWAITE & M. COLLINS, *INTERNATIONAL CORPORATE TAXATION* (1980 & Supp. 1985) and P. POSTLEWAITE & M. COLLINS, *INTERNATIONAL INDIVIDUAL TAXATION* (1982 & Supp. 1985).

¹³ I.R.C. §§ 871(b) and 882. Such income is said to be "effectively connected" with the conduct of a trade or business within the United States and thus, is not subject to the provisions of I.R.C. §§ 871(a) and 881(a).

¹⁴ I.R.C. §§ 871(a) and 881(a) impose a 30% withholding tax on U.S. source income that is "fixed or determinable, annual or periodical" and that is not "effectively connected with the conduct of a trade or business within the United States." Such income may include salaries, interest, dividends, rents, royalties and similar items. I.R.C. §§ 871(a)(1)(A) and 881(a)(1). Articles on the application of the withholding tax include Dale, *Withholding Tax on Payments to Foreign Persons*, 36 TAX L. REV. 49 (1980) (and sources cited therein at n.16); and Note, *The Scope of the Withholding Tax on Payments to Aliens: A Survey*, 22 COLUM. J. TRANSNAT'L L. 359 (1984) (and sources cited therein at n.23).

In this context, the term "withholding tax" does not refer merely to the method of tax collection; it also represents the effective tax imposed. *Minor Tax Bills: Hearings before the Subcomm. on Select Revenue Measures of the Comm. on Ways & Means*, 96th Cong., 2d Sess. 7 (1980) Serial 96-115 (statement of Donald Lubick, Asst. Sec'y for Tax Policy, Dept. of Treasury) [hereinafter cited as *Minor Tax Bills*]. The imposition of the 30% withholding tax is subject, however, to certain statutory exemptions and treaty reductions. See *infra* note 20.

¹⁵ I.R.C. §§ 1441(a) and 1442(a). Sec. 127(e) of the 1984 Act added an exception to these Code sections for "portfolio interest." See I.R.C. § 1441(c)(9), which provides an exception for withholding on interest income from "portfolio debt investments" unless the withholding agent "knows, or has reason to know, that such interest is not portfolio interest by reason of § 871(h)(3)."

nesses have financed their operations.¹⁶ In an effort to reduce the interest rates they were paying on debt, corporations began as early as the 1960s to access an alternative supply of investment funds by offering their debentures to foreign investors in the Eurobond market.¹⁷ The imposition of the thirty percent withholding tax on interest paid to these investors, however, initially made this an unattractive mode of financing. Since foreign investors could invest in the debt obligations of governments and businesses of other countries without the payment of such taxes,¹⁸ a United States offeror would have had to increase the yield of its obligation by forty-three percent¹⁹ in order to compensate the investor for the thirty percent United States withholding tax and to compete with other issuers. This prospect was totally unacceptable to most United States issuers. Moreover, while there were several exceptions to the rule requiring withholding,²⁰ such provisions would not allow direct issuance of the

¹⁶ An investor typically looks at two fundamental elements when considering how much of his funds to allocate to an investment: the expected return and the riskiness of the investment. To the extent that taxes reduce the investors return (by up to 30% of the stated rate of return under the withholding rules), the investor is likely to allocate less of his funds to that investment, assuming that taxes on similar types of investments are less. CONGRESSIONAL RESEARCH SERVICE, U.S. ECONOMIC POLICY IN AN INTERNATIONAL CONTEXT: THE 30 PERCENT WITHHOLDING TAX AND THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT: TWO ISSUES IN THE TAXATION OF FOREIGN INVESTMENT, 9-10 (MAY 30, 1984) RPT. NO. 84-60E [hereinafter cited as CRS STUDY].

¹⁷ The Eurobond market is a segment of the Eurocurrency market; as such, the bonds issued in that market are acquired by investors with funds deposited outside the borrower's country. Since the bonds are issued outside the borrower's country, the market is largely unregulated and untaxed. Thus, borrowers can raise funds more quickly and more easily, and generally, at a lower cost than in their home country. Eurobonds are generally issued in bearer form, allowing the investor anonymity, and the interest is paid free of withholding taxes. Baxter, *International Financial Markets and Loans: An Introduction to the Legal Context*, 10 CAN. BUS. L.J. 198 (1985). In addition to lower interest rates, the Eurobond market generally allows borrowers to utilize early redemption agreements and more flexible debt covenants than are available in the domestic financing market. Taylor, *Foreign Financings by U.S. Companies*, 41 INST. ON FED. TAX'N § 26.02 at 26-3 (1983).

¹⁸ In the Eurobond market the debt obligations, issued in bearer form, are free of taxes withheld at source. This may be because there is no withholding tax imposed (the Netherlands), because there is a specific exemption for Eurobonds (Australia, Canada, or France), or because no withholding tax is imposed on borrowings through finance subsidiaries. *Id.* at 26-3. Eurobond issues are usually marketed on an indemnified basis wherein the issuer agrees to absorb the cost of any tax which might be imposed as a result of a change in the tax laws. Alternatively, the bonds may also be callable at the issuer's option. EXPLANATION OF THE 1984 ACT, *supra* note 6, at 389.

¹⁹ Taylor, *supra* note 17, at 26-4 ($\$1.00 \div 70\% = \1.43 or $70\% \times 1.43 = \$1.00$).

²⁰ Statutory exceptions to the imposition of the 30% withholding tax prior to the 1984 Act included:

- a) capital gains income earned by foreign investors;
- b) interest from deposits in U.S. banks (I.R.C. §§ 861(a)(1)(A) and 861(c));
- c) original issue discount on obligations maturing in six months or less from the original issue date (I.R.C. §§ 871(a)(1)(A) and (C), 871(g)(1)(B), 881(a)(1) and (3));
- d) interest paid by a domestic corporation which earns less than 20% of its gross income from sources within the United States (an "80/20 company") (I.R.C. §§ 861(a)(1)(B));
- e) income paid to foreign governments or instrumentalities on investments in U.S. interest bearing obligations held in non-commercial contexts (I.R.C. § 892).

type of obligations sold in the Eurobond market.²¹

In an effort to overcome these barriers, corporations began to issue their obligations to foreign investors through foreign "finance subsidiaries" located in a country with which the United States had a treaty exempting interest payments.²² Corporations generally chose the Netherlands Antilles as the site for incorporation of the finance subsidiary because of the favorable terms of the United States - Kingdom of the Netherlands Income Tax Convention, as extended to the Netherlands Antilles (U.S.-N.A. Treaty)²³ and the Netherlands Antilles' internal tax structure.²⁴ The Antillean finance subsidiary would issue its own obliga-

Tax treaties between the United States and various other countries also contain exceptions to or reductions in the rate of the imposition of the 30% withholding tax on interest or dividends. The exemption is based on the assumption that the income will be taxed by the recipient's country of residence. Treaties under which the withholding rate is reduced to zero include those with Austria, Denmark, Finland, West Germany, Greece, Hungary, Iceland, Ireland, Luxembourg, the Netherlands, the Netherlands Antilles, Norway, Poland, Sweden, the U.S.S.R. and the United Kingdom. Treaties with the following countries allow for reciprocal rate reductions: Belgium, Canada, Egypt, Morocco, the Philippines (15%), Jamaica, Malta (12.5%), Korea (12%), France, Japan, Romania (10%) and Switzerland (5%). Some treaties exempt only certain types of interest (such as bank interest or interest on public debt). JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., TAX TREATMENT OF INTEREST PAID TO FOREIGN INVESTORS 3-4 (Comm. Print 1984) JCS 23-84 [hereinafter cited as JOINT COMMITTEE PRINT OF 1984].

²¹ Such exemptions or reductions do not allow direct issuance of United States corporate obligations in the Eurobond market because (1) the United States does not have treaties with all countries; (2) in some cases, the withholding tax is merely reduced; and (3) treaty benefits extend only to residents of the treaty country, so that resale of the obligation may be difficult. Taylor, *supra* note 17, at 26-6. Moreover, in the case of bearer obligations, there is no way to know the residence of the owner so as to ensure that the owner is entitled to treaty benefits.

²² The use of finance subsidiaries began at a time in the 1960s when corporations began to borrow in the Eurobond market because of a government program to prevent the devaluation of the dollar through fixed exchange rates. Several programs were developed to encourage companies to borrow overseas: the Interest Equalization Tax (IET), the Foreign Direct Investment Program, and the Voluntary Foreign Credit Restraint Program. There was also a general relaxation of the no-action letter policy of the SEC as to foreign bond issues and a change in IRS ruling policy which encouraged the use of foreign finance subsidiaries. IRS rulings provided, in general, that such subsidiaries would be respected as separate entities, and that no withholding tax would be imposed where the subsidiary's debt-to-equity ratio did not exceed 5:1 and certain other conditions were present. Rev. Rul. 73-110, 1973-1 C.B. 454; Rev. Rul. 72-416, 1972-2 C.B. 591; Rev. Rul. 70-645, 1970-2 C.B. 273; Rev. Rul. 69-501, 1969-2 C.B. 233; Rev. Rul. 69-377, 1969-2 C.B. 231; JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 9.

²³ The United States-Kingdom of the Netherlands Income Tax Convention of April 29, 1948, 62 Stat. 1757, T.I.A.S. No. 1855 (T.D. 5778, 1950-1 C.B. 92), as modified and supplemented by the Protocol of June 15, 1955, 6 U.S.T. 3703, T.I.A.S. No. 3367 (1956-2 C.B. 1116), and by the Protocol of October 23, 1963, 15 U.S.T. 1900, T.I.A.S. No. 5665 (1965-1 C.B. 624), applies to the Netherlands Antilles [hereinafter cited as the U.S.-N.A. treaty].

The U.S.-N.A. treaty has been under active renegotiation for over four years. See *infra* note 35.

²⁴ See *infra* note 26. A finance subsidiary could be established in any country with which the United States has a treaty providing for a low or zero rate of withholding on U.S. source interest income and where there are local laws exempting withholding on interest paid to nonresidents. Sarafopoulos, *Eurobond Financings: Current Techniques and New Proposals*, 9 INT'L TAX J. 399, 402

tions in the Eurobond market, with the United States parent guaranteeing the bonds. Proceeds of the offering were then reloaned to the United States parent on the same terms as the Eurobond issue, but at one percent over the rate to be paid on the Eurobonds. Payments of interest and principal could, through the use of the U.S.-N.A. treaty, pass tax-free from the United States parent to the Antillean finance subsidiary,²⁵ interest and principal paid to the foreign investor were also tax-free.²⁶ The Antillean finance subsidiary would realize net income for the one percent interest differential, on which the Antillean government imposed a tax of about thirty percent.²⁷ However, the United States parent was allowed an offsetting credit on its corporate income tax return for these taxes paid to the Antillean government.²⁸ Indirectly, this credit resulted in a transfer of tax revenues from the United States Treasury to that of the Antillean government.²⁹

The use of the Netherlands Antilles as an outlet for the issuance of Eurobonds increased over the years³⁰ as the volume of Eurobond financ-

n.14 (1983). See also Gelinas, *Tax Considerations for U.S. Corporations Using Finance Subsidiaries to Borrow Funds Abroad*, 7 J. CORP. TAX'N 230 (1980).

If a company is seeking funds for use abroad it can establish a finance subsidiary in the United States (a so-called "80/20 company"). See JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 7-11 for a description of this type of finance subsidiary arrangement.

²⁵ Art. VIII of the U.S.-N.A. treaty provides that interest received by an Antillean corporation from U.S. sources is exempt from withholding taxes. Although Art. I(1) of the protocol denied this exemption to Antillean investment companies (such as a finance subsidiary), the Internal Revenue Service (the "Service"), in Rev. Rul. 65-16, 1965-1 C.B. 626, stated that the exemption would apply to such companies if they elected to be taxed at regular Antillean corporation profits tax rates. Sarafopoulos, *supra* note 24, at 403; Gelinas, *supra* note 24, at 240-41. See *infra* note 127 for the exact wording of Art. VIII.

²⁶ Art. XII of the U.S.-N.A. treaty provides an exemption from U.S. tax for interest paid by a Antillean corporation unless the recipient is a citizen, resident or corporation of the United States. Furthermore, the Antillean government does not impose withholding taxes on interest from debt obligations of Antillean corporations paid to nonresidents. Gelinas, *supra* note 24, at 240.

²⁷ *Id.* at 241.

²⁸ The finance subsidiary is considered a "controlled foreign corporation" under I.R.C. §§ 951(b) and 957(a) (defined *infra* note 52), and, accordingly, its net income is treated as a deemed dividend distribution under I.R.C. § 951 Subpart F provisions. The dividend was classified as foreign-source income prior to the 1984 Act, Treas. Reg. § 1.960-1(h)(1), and accordingly, entitled the U.S. parent to a deemed foreign tax credit under I.R.C. § 960. Sarafopoulos, *supra* note 24, at 405. Under new I.R.C. § 904(g), such income will now be classified as U.S. source income, thus reducing the foreign tax credit limitation.

²⁹ A transfer resulted to the extent that the U.S. corporation's tax liability was reduced by taxes paid to the Antillean government. Taylor, *supra* note 17, at 26-21.

³⁰ The amount of portfolio interest paid to foreign persons through the Netherlands Antilles increased from \$97 million in 1977 to \$1 billion in 1981, and to almost \$1.5 billion in 1982. These figures represented, respectively, 19%, 31% and 29% of total portfolio interest paid in those years. JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 12; 1983-84 Misc. Tax Bills VI: S. 1066, S. 1550, S. 1557 and S. 1666: Joint Hearings before the Subcomm. on Savings, Pension, & Investment Policy and Subcomm. on Taxation & Debt Management of the Senate Comm. on Finance, 98th

ing by United States companies grew. In 1978, Eurobond issuances by these companies amounted to \$1.1 billion.³¹ For the first seven months of 1984 (prior to the passage of the 1984 Act), this figure was \$5.0 billion.³²

As United States corporate use of finance subsidiaries increased over the years, pressures began to mount against the use of this financing technique. Those who favored direct issuance of Eurobonds (mainly corporate executives and the securities industry) argued that the use of a finance subsidiary was a costly, complicated procedure which was not only inefficient, but which also kept smaller companies from accessing the Eurobond market.³³ Additionally, critics of the treaty system pointed out that nonresidents were utilizing bilateral treaties for treaty-shopping purposes.³⁴ While termination and renegotiation of treaties could be used to combat such abuses, Treasury was reluctant to adopt this approach with the Antilles because of the adverse effects that redemption of existing Eurobond issues would have on United States credit markets.³⁵ Moreover, the Internal Revenue Service (the Service) had

Cong., 1st Sess. 30-31 (1983) [hereinafter cited as *Hearings on S. 1557*]; STAFF OF JOINT COMM. ON TAXATION, 96TH CONG., 2D SESS., DESCRIPTION OF H.R. 7553 RELATING TO EXEMPTIONS FROM U.S. TAX FOR INTEREST PAID TO FOREIGN PERSONS, 12-13 (Comm. Print June 1980) JCS 29-80. In the sense used in this footnote, "portfolio interest" means interest, received by a person residing in a foreign country, on debt instruments with maturities of more than one year. U.S. TREASURY DEP'T., REPORT TO THE CONGRESS ON FOREIGN PORTFOLIO INVESTMENT IN THE UNITED STATES vii (1976).

³¹ JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 20.

³² Wall St. J., Oct. 15, 1984, at 34, col. 1 (estimated on basis of graph). This figure would likely be higher were it not for the uncertainties in the relevant tax laws which existed throughout the first half of 1984. Total 1984 Eurobond issues by U.S. companies amounted to \$18.6 billion. Wall St. J., Jan. 2, 1985, at 16, col. 2. Many believe that this large gain is indicative of the success of the repeal legislation.

³³ Rep. Sam Gibbons, in his push to enact his repeal bill, H.R. 3025, frequently referred to the withholding tax as a tariff on small business. This attack is perhaps best illustrated in the hearings held on H.R. 3025 and H.R. 4029 (the Barnard bill). *May 1, 1984 Hearings, supra* note 3, at 42-43.

³⁴ Treaty shopping may be defined as the use of a tax treaty by third country investors to avoid the payment of any taxes on the income they derive, not just to avoid double taxation thereon. The use of treaty shopping has been the focus of several recent articles and congressional investigations, and has been the Treasury Department's prime reason for seeking to renegotiate the U.S.-N.A. treaty. For information on this subject, see Comment, *Income Tax Treaty Shopping: An Overview of Prevention Techniques*, 5 NW. J. INT'L L. & BUS. 626 (1983), and sources cited therein; Freud, *Treaty Shopping and the 1981 U.S. Treasury Draft Model Income Tax Treaty*, 6 HASTINGS INT'L & COMP. L. REV. 627 (1983) and sources cited therein; IRS, TAX HAVENS AND THEIR USE BY U.S. TAXPAYERS—AN OVERVIEW, (1981) (prepared by Richard A. Gordon) [hereinafter cited as TAX HAVENS], updated in DEPT. OF TREASURY, TAX HAVENS IN THE CARIBBEAN BASIN, (Jan. 1984); *Tax Evasion Through the Netherlands Antilles and Other Tax Haven Countries: Hearings before the Subcommittee of the Committee on Government Operations*, 98th Cong., 1st Sess. (1983) [hereinafter cited as *Hearings on Tax Evasion*]; *Offshore Tax Havens: Hearings before the Subcommittee on Oversight of the Comm. on Ways and Means*, 96th Cong., 1st Sess. (1979).

³⁵ See *infra* note 192. The U.S.-N.A. treaty has been in various stages of renegotiation for over

begun to question the validity of finance subsidiary operations on audit, arguing, under several theories, that while the Eurobond obligations were, in form, those of the finance subsidiary, that in substance, they were obligations of the domestic parent and, thus, subject to the thirty percent withholding tax.³⁶ Finally, changes were proposed in both the House and Senate versions of the 1984 Act that would have eliminated the foreign tax credit taken by the United States parent for taxes paid by the finance subsidiary to the Netherlands Antilles.³⁷ The proposed

four years. The Treasury Department believes that it is receiving an insufficient information exchange from the Antillean government on tax evasion, criminal activities, and drug operations involving U.S. taxpayers. *Hearings on Tax Evasion, supra* note 34, at 571. See also Comment, *Renegotiations of the U.S.-Netherlands Antilles Tax Treaty*, 18 TEX. INT'L L.J. 400 (1983).

³⁶ This argument would be based on the theory that the finance subsidiary is inadequately capitalized. The Service's position in its earlier rulings respected the finance subsidiaries as independent entities if their debt-to-equity ratio was no greater than 5:1, see *supra* note 22. Concurrent with the U.S. government's decision to abandon the fixed-exchange rate system in 1974, the Service revoked those earlier rulings and, in a separate ruling, stated that, "the mere existence of a five to one debt-to-equity ratio . . . should no longer be relied upon" as a basis for the conclusion that the obligations of the subsidiary in fact represent debt of the subsidiary (rather than that of the guarantor). Rev. Rul. 74-464, 1974-2 C.B. 46. Subsequent bond issues through finance subsidiaries therefore relied on opinions of counsel, who usually recommended that the subsidiary have a more conservative debt-to-equity ratio (3:1 or lower) and that it have assets, equal to its equity, not loaned back to the guarantor. Taylor, *supra* note 17, at 26-11.

In addition to attacking the finance subsidiary operation on the inadequate capitalization theory, the Service might also challenge its existence on the agency or conduit theory, *i.e.*, because the subsidiaries are largely paper corporations whose obligations are guaranteed by the U.S. parent, the subsidiary's bonds might, in substance, be treated as the debt obligation of the U.S. parent. *Aiken Industries*, 56 T.C. 925 (1971). The Service might also attempt, though probably unsuccessfully, to disregard the subsidiary as a separate legal entity; but see *Perry R. Bass*, 50 T.C. 595 (1968). Gelinas, *supra* note 24, at 250-55. See also Rev. Rul. 84-152, *infra* note 125, which may support any or all of these three theories because of its potentially broad application and rationale. Finally, the use of the finance subsidiary might be viewed as having as its principal purpose the avoidance of the withholding tax on its parent, with the result that the treaty exemption might not apply. I.R.C. § 269.

As of late 1983, there were at least 25 IRS audits challenging finance subsidiary transactions. One company, Texas International, disclosed the existence of such an audit in its proxy statement. See 46 TAXES INT'L 13 (Aug. 1983).

³⁷ Provisions in both the House and Senate bills sought to recharacterize the interest income of the finance subsidiary as U.S. source income, thereby reducing or eliminating the foreign tax credit for Antillean taxes paid by the finance subsidiary (§§ 141 and 142 of H.R. 4170 and §§ 128 and 129 of H.R. 2163). Thus, unless a large enough interest rate differential could be obtained in the Eurobond market to offset the loss of the tax credit (which most experts thought unlikely), companies would no longer be able to achieve any savings by using the Antillean Eurobond route. JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 17. Moreover, forcing companies back into the U.S. domestic financing market would probably have resulted in higher overall interest rates, which Congress and the Administration sought to avoid.

The recharacterization provision was, in fact, enacted as I.R.C. § 904(g). As direct access to the Eurobond market was provided by the 1984 Act, however, the provision was not fatal to Eurobond financings. Until it became clear that the withholding tax would be repealed, the presence of these resourcing rules created great uncertainty for companies planning Eurobond issues through the Antilles. BUS. WK., Apr. 16, 1984, at 154. I.R.C. § 904(g) will, however, affect companies

changes threatened to halt Eurobond financings unless some other form of access were created. These factors, combined with the overwhelming influence of the Treasury Department and its desire to finance government deficits at a lower cost,³⁸ ultimately pushed Congress to approve a repeal of the thirty percent withholding tax on interest paid to foreign investors.

C. The Repeal Proposals

Members of Congress began to propose a repeal of the thirty percent withholding tax on portfolio interest as early as 1975.³⁹ These proposals, however, were unpopular with the legislative majority of the day and, thus, met with little success.⁴⁰ By the 98th Congress, the legislators'

whose Eurobond issues were "grandfathered" by § 127(g)(3) of the Act. See *infra* note 76 and accompanying text.

³⁸ The Treasury Department actively supported H.R. 3025, a bill which would have repealed withholding on a broad class of securities and allowed the federal government to market its obligations in the foreign market on a tax-free basis, and thus, at a lower interest rate. Although two investment banking firms—First Boston and Morgan Guaranty—sought to keep the federal government out of the competition for foreign funds on the theory that it would drive up Eurobond interest rates, Treasury officials were not sympathetic: "We cannot accept the argument that Treasury should pay more so that some U.S. corporations may pay less." *May 1, 1984 Hearings, supra* note 3, at 26 (statement of Ronald Pearlman of the Treasury Dept.). See also 23 TAX NOTES 322 (Apr. 16, 1984).

Many viewed the broad form of repeal which Treasury supported as the measure most likely to increase tax evasion by U.S. citizens through purchases of bearer bonds. Thus it was ironic that Treasury had a foot in both camps—though it sought to prevent tax evasion, it also wanted to lower the enormous costs of financing the federal government. 24 TAX NOTES 325 (Jul. 23, 1984). The extent of Treasury support was illustrated when, in a rare move, then-Secretary of the Treasury Donald Regan met with House and Senate conferees in private session during the conference on the 1984 Act to urge passage of the repeal legislation. *Id.*

³⁹ In considering the Tax Reform Act of 1976, the House Committee on Ways and Means voted to repeal the 30% withholding tax on both interest and dividends. However, the provision was removed from the bill by the House of Representatives on December 4, 1975 by a vote of 301-119. 121 CONG. REC. 38,686-87 (1975). The Senate Committee on Finance then proposed an amendment which would repeal withholding only on interest. The Senate deleted this amendment from the bill on the Senate floor on July 26, 1976 by a vote of 54-34. 122 CONG. REC. 23,874-80 (1976).

Hearings were held in 1976 on the repeal issue. *Foreign Portfolio Investments in the United States: Hearings Before the Subcommittee on International Finance and Resources of the Senate Committee on Finance*, 94th Cong., 2d Sess. (1976) [hereinafter cited as *1976 Hearings on Foreign Investment*]. These early materials contain the best summary of arguments in opposition to the repeal measures.

In December 1979, the Senate Finance Committee reported H.R. 2297 (a bill to suspend duties on synthetic rutile) with committee amendments to repeal the withholding tax on interest paid to foreign investors. H.R. 2297, 96th Cong., 1st Sess., 125 CONG. REC. 36,330 (1979). H.R. 7553, identical to H.R. 2297, was reported from the House Ways & Means Committee. H.R. 7553, 96th Cong., 2d Sess., 126 CONG. REC. 14,049 (1979). Hearings were held on H.R. 7553 in June 1980. *Minor Tax Bills, supra* note 14. Neither the House nor the Senate acted on these bills.

⁴⁰ Though the early proposals were similar to the enacted legislation, those proposals met with little success. Several factors probably contributed to the success of the repeal legislation during the

views had changed somewhat, and four repeal measures were proposed. An overview of these proposals is helpful to an analysis of the policy issues underlying the repeal legislation.

(1) *Gibbons-Conable (H.R. 3025) and Chafee-Bentsen (S. 1557)*.⁴¹ H.R. 3025 and S. 1557 would have exempted from withholding portfolio interest received on three categories of debt: assumed,⁴² bearer⁴³ and registered.⁴⁴ As a broad form of immediate repeal, the bill granted direct access to foreign capital markets to United States businesses, the federal government, and governmental agencies.⁴⁵

98th Congress, including the increased importance of capital markets to the U.S. economy and the financial expertise and aggressiveness of then-Treasury Secretary Donald Regan, a former Wall Street banker.

⁴¹ H.R. 3025, 98th Cong., 1st Sess., 129 CONG. REC. E2296 (daily ed. May 17, 1983); S. 1557, 98th Cong., 1st Sess., 129 CONG. REC. S9334 (daily ed. Jun. 28, 1983). In July 1983, the first hearings were held on H.R. 3025 (proposed by Reps. Gibbons and Conable). *Revenue Increase Proposals: Hearings before the Comm. on Ways & Means*, 98th Cong., 1st Sess. (1983) Serial 98-48 [hereinafter cited as *Revenue Increase Proposals*]; see also *May 1, 1984 Hearings*, *supra* note 3, on H.R. 3025 and a description of the bill in JOINT COMMITTEE PRINT OF 1984, *supra* note 20. Later, in September 1983, two Senate Finance Subcommittees held a joint hearing on S. 1557 (a companion bill to H.R. 3025 that was similar, though not identical to it). *Hearings on S. 1557*, *supra* note 30. The Senate Finance Committee, however, took no action at that time.

⁴² "Assumed" debt referred to debt obligations of U.S. corporations that would have been issued on or prior to the date of enactment. The obligations would have to have been guaranteed by the U.S. corporation at issuance and sold under "arrangements reasonably designed to ensure that they would be sold (or resold) only to non-U.S. person." This provision would have allowed U.S. corporations to assume the outstanding obligations that they had issued through Antillean finance subsidiaries and to pay interest on those obligations on a tax-free basis. JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 14.

⁴³ "Bearer" debt refers to debt which is not in registered form, but rather, which is payable to the person in physical possession of the obligation. Such debt would include only those obligations (1) sold under procedures reasonably designed to prevent sale to U.S. persons and (2) where the interest would be payable outside the U.S. and its possessions. *Id.* In addition, S. 1557 required that the face of any bearer obligation contain a statement that U.S. holders would be subject to limitations under U.S. income tax laws. *Hearings on S. 1557*, *supra* note 30, at 34.

These three requirements for bearer debt exemption were included in the repeal legislation by reference to I.R.C. § 163(f)(2)(B) and have been amplified by recent treasury regulations. See *infra* note 62 and accompanying text.

⁴⁴ Interest would be exempt on an obligation in "registered" form if the U.S. payor received a statement that the beneficial owner of the obligation was not a U.S. person. That statement could be received from the beneficial owner or from a bank, securities clearing organization or other financial institution holding customer's securities in the ordinary course of its trade or business. The statement would not, however, have required identification of the beneficial owner. JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 14. While this definition of registered debt was retained in the repeal legislation itself, Temp. Treas. Reg. § 35a.9999-5(b), Q & A 9 requires identification of the beneficial owner.

⁴⁵ The main difference between H.R. 3025 and H.R. 4029 was the inclusion of the federal government and its agencies among those who could issue tax-free debt to foreigners. See *supra* note 38.

The repeal legislation as enacted allows the Treasury to issue its securities tax-free, but on the

(2) *Senate Proposal: Section 142 of the Deficit Reduction Act of 1984.*⁴⁶ Though the substantive provisions of this section were similar to those of H.R. 3025 and S. 1557, section 142 called for a reduction in the withholding rate from thirty percent to five percent on an immediate basis, with a phase-out in the rate to occur by June 30, 1988.⁴⁷ This delayed phase-out reflected Congressional concern for the future of the Antillean economy, which would be adversely affected by an immediate repeal.⁴⁸

(3) *Barnard bill (H.R. 4029).*⁴⁹ H.R. 4029 adopted an immediate repeal approach, but limited the repeal to Eurobond interest paid by United States corporations. No exemption was to be provided for interest paid to foreigners on registered bonds or on government or government agency obligations.⁵⁰

Each of the above proposals included:

—exceptions to the repeal for interest received by ten percent-or-more owners of payor corporations or partnerships;⁵¹

decision of then-Secretary Regan, the securities will be sold in "foreign-targeted" registered form and not in bearer form. See *infra* notes 93-106 and accompanying text.

⁴⁶ H.R. 2163, 98th Cong., 2d Sess. § 142 (1984).

⁴⁷ Industry did not favor this proposal, pointing out that even a low rate of withholding would eliminate the advantage of Eurobond financing because the savings accruing from such financing were generally less than 100 basis points. *May 1, 1984 Hearings, supra* note 3 at 89-91. Moreover, they noted, combining the effects of a phased-in withholding with those of the income resourcing rules would only exacerbate the problem. See *supra* note 37.

⁴⁸ 23 TAX NOTES 552 (Apr. 30, 1984). Reports estimated that the Antillean government derived as much as 25% of its annual budget through direct tax revenues received from Antillean finance subsidiaries. This figure does not include the indirect revenues which resulted from increased employment and support services. See *infra* note 198 and accompanying text; *May 1, 1984 Hearings, supra* note 3, at 118-25 (statement of Prime Minister Dominico Martina). Whether the Senate proposal would have softened the blow to the Netherlands Antilles is doubtful; it was more likely to halt Eurobond financings, because even a small rate of withholding could eliminate any cost savings achieved by using the Eurobond market. See *supra* note 47. The repeal legislation as enacted does, however, provide some relief to the Antillean economy since companies cannot assume debt in existence on the date of enactment. Thus, the Antillean economy will continue to derive tax revenues from the servicing of that debt. See *infra* note 76 and accompanying text.

⁴⁹ H.R. 4029, 98th Cong., 1st Sess., 129 CONG. REC. E4642 (daily ed. Sept. 29, 1983). Hearings were held on H.R. 4029 in 1984. *May 1, 1984 Hearings, supra* note 3. For a description of H.R. 4029, see JOINT COMMITTEE PRINT OF 1984, *supra* note 20.

⁵⁰ See *supra* note 45.

⁵¹ Interest on bearer or registered debt, if paid to a foreign investor who had a "direct ownership interest" in the U.S. payor, would be ineligible for the exemption. A direct ownership interest would exist, in the case of interest paid by a domestic corporation or a domestic partnership, if the investor owned, directly or indirectly (using constructive ownership rules) (a) in the case of a domestic corporation, 10% or more of the total combined voting power of all classes of stock entitled to vote in that corporation or (b) in the case of a domestic partnership, 10% or more of the capital or profits interest of the partnership. JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 16.

Utilizing the attribution rules of I.R.C. § 318(a), as modified by I.R.C. §§ 871(h)(3)(C)(i) and (ii), this direct ownership restriction is embodied in the enacted legislation as I.R.C. § 871(h)(3).

- exceptions to the repeal rules for interest received by controlled foreign corporations⁵² and by foreign banks on extensions of credit pursuant to loan agreements entered into in the ordinary course of business,⁵³ and for interest income “effectively connected” with the conduct of a United States trade or business.⁵⁴
- provisions allowing the Secretary of the Treasury to remove the exemption where the exchange of information with other countries was deemed inadequate,⁵⁵
- elimination of United States estate tax on obligations for which interest was exempted.⁵⁶

(4) *Joint Tax Committee Proposal:* An excise and an income tax of two

Under I.R.C. § 871(h)(3), interest received by 10% owners is excluded from the definition of “portfolio interest.”

⁵² Under these proposals, the 30% withholding tax would be retained for interest paid on bearer or registered debt of U.S. persons to a controlled foreign corporation (CFC). A CFC is a corporation in which more than 50% of the voting interest is owned by U.S. shareholders on any day in the corporate tax year. I.R.C. § 957(a). A U.S. shareholder is a U.S. person who actually or constructively owns 10% or more of a foreign corporation's voting interest. I.R.C. § 951(b). The withholding tax was retained in this case to ensure that some tax would be paid because of the following prior tax provisions allowing U.S. shareholders to use their CFCs to avoid taxes:

(1) Under prior law, dividends paid by a CFC which were attributable to interest on U.S. loans were foreign source income. In effect, this allowed conversion of U.S. source income to foreign source income and, consequently, resulted in a higher limitation on the foreign tax credit. This provision was amended by the 1984 Act, however, so that such income now retains its U.S. source. *See supra* note 37.

(2) A CFC could defer U.S. tax on its foreign source income if investment interest was less than 10% of its gross income. Thus, current interest deductions could be taken by a U.S. debtor even though the CFC could defer recognition of the interest income. The changes in the 1984 Act remove such interest income from this provision by preventing its resourcing into foreign source income. JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 15.

Under the 1984 Act, portfolio interest paid to a CFC will be exempt unless the interest is paid by a related person under I.R.C. § 864(d)(4). *See infra* note 68.

⁵³ Withholding on interest paid to foreign banks in these cases would serve to discourage those banks from lending to U.S. persons through offshore branches which were not subject to U.S. banking regulations, a practice of concern to the Federal Reserve Board. JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 15-16.

The 1984 Act retains this restriction, with an exception for interest paid on an obligation of the U.S. government. I.R.C. § 881(c)(3)(A).

⁵⁴ Such income is subject to tax at the regular rates applicable to such a business. *See supra* note 13.

⁵⁵ The information sought to be exchanged would generally relate to information from other governments on tax evasion activities by U.S. persons. The removal of the exemption would apply only to interest payments on future issuances of debt obligations and would continue only until the Secretary has determined that sufficient information was being received to identify the recipient of the interest. JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 16.

The 1984 Act retains this provision in I.R.C. §§ 871(h)(5) and 881(c)(5).

⁵⁶ JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 15. Such treatment would be consistent with the taxing scheme of the estate tax on nonresident aliens. The 1984 Act adopted this exclusion in sec. 127(d) of the 1984 Act, which amended I.R.C. § 2105(b) (Property outside the U.S.—not included in decedent's estate). *See infra* note 77.

and one-half percent to three percent were each suggested in lieu of complete repeal. Concerns over treaty conflicts and fears that even a small tax rate would eliminate the Eurobond advantage, however, resulted in general disapproval of these proposals.⁵⁷

The repeal legislation adopted in the 1984 Act differs somewhat from each of these proposals, but most nearly follows the provisions of H.R. 3025 and S. 1557. Unlike those proposals, however, it excludes assumed debt from the repeal provisions. The legislation enacted thus also extend to issues of the federal government and governmental agencies.

III. THE NEW LAW—SECTION 127 OF THE DEFICIT REDUCTION ACT OF 1984

A. Statutory Provisions

Under the provisions enacted, complete repeal of the thirty percent rate of withholding became effective on July 18, 1984.⁵⁸ The repeal applies only to interest paid on obligations issued after the date of enactment.⁵⁹ Thus, obligations in existence on that date cannot be assumed by the United States parent without payment of the thirty percent withholding thereon.⁶⁰

The exemption from withholding applies only to "portfolio interest" paid to non-resident alien individuals and to foreign corporations with respect to two categories of debt: bearer and registered.⁶¹ With respect

⁵⁷ Rep. Stark believed that a low rate of withholding would be a good compromise to the compliance and trade deficit problems associated with the total elimination of the 30% withholding tax. He compared this proposal to the Japanese system, noting that the latter had managed to keep the yen well-controlled. 24 TAX NOTES 327 (Jul. 23, 1984).

Most observers, however, believed that even a 2-3% rate of withholding would severely hamper the operation of the Eurobond market because it would increase the interest costs on financing beyond the savings accrued through the use of that market. Letter from William McClure, Esq. to the Treasury Department. 23 TAX NOTES 1025 (Jun. 4, 1984). Furthermore, it was feared that if the 2½-3% excise tax did not override the U.S.-N.A. treaty, it would have the effect of maintaining the finance subsidiary system, with its related costs. Letter from Rep. Doug Barnard to Asst. Secretary John Chapoton. 22 TAX NOTES 740 (Feb. 20, 1984).

⁵⁸ Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 648 (signed into law on July 18, 1984).

⁵⁹ § 127(g) of the 1984 Act states: "Except as otherwise provided in this subsection, the amendments made by this section shall apply to interest received after the date of the enactment of this Act with respect to obligations issued after such date, in taxable years ending after such date."

Congress excluded pre-existing obligations from the repeal legislation so as to give the N.A. economy time to adjust to the effects of the legislation. EXPLANATION OF THE 1984 ACT, *supra* note 6, at 392.

⁶⁰ CONFERENCE REPORT ON THE DEFICIT REDUCTION ACT OF 1984, H.R. REP. NO. 861, 98th Cong., 2d Sess. 937 (1984) [hereinafter cited as CONFERENCE REPORT].

⁶¹ I.R.C. §§ 871(h)(1) and 881(c)(1).

to bearer debt, I.R.C. § 871(h)(2)(A) defines “portfolio interest” as interest paid on any obligation that is not in registered form and that is described in § 163(f)(2)(B). An obligation is described in § 163(f)(2)(B) if:

- (1) the obligation is sold under arrangements reasonably designed to prevent sales (or resales in connection with the original issue) to United States persons;
- (2) interest on the obligation is payable only outside the United States and its possessions; and
- (3) the face of the obligation contains a statement that United States holders are subject to limitations under the United States income tax laws.⁶²

⁶² I.R.C. § 163(f)(2)(B). These three requirements, known as the “foreign-targeted” exception to the issuance of registered debt, are interpreted in Temp. Treas. Reg. § 1.163-5(c)T(1) and (2) (T.D. 7965, 49 Fed. Reg. 33,230, *reprinted in* 1984-2 C.B. 38), and are effective for obligations issued to foreign persons after September 21, 1984.

These temporary regulations add an additional requirement, not included in I.R.C. § 871 or § 881, that the obligations must be “registration-required” within the meaning of I.R.C. § 163(f)(2)(A) in order to qualify as “portfolio interest” and to be eligible for the exemption from withholding. In essence, this means that the obligations (1) cannot be issued by a natural person, (2) must be of a type offered to the public, and (3) must have maturities of more than one year. Temp. Treas. Reg. § 35a.9999-5(a), Q&A-1. *See infra* notes 107-24 and accompanying text for a criticism of this requirement.

The determination of whether an obligation meets the requirements of I.R.C. § 163(f)(2)(B) is made on an obligation-by-obligation basis. An obligation originally issued in registered form but later converted to bearer form will not meet the requirements of I.R.C. § 163(f)(2)(B). Temp. Treas. Reg. § 1.163-5(c)T(1).

An obligation is considered to have been issued under arrangements reasonably designed to ensure sale to non-United States persons if it meets the requirements of one of three paragraphs in the Temporary Regulations. Temp. Treas. Reg. § 1.163-5(c)T(2)(i). The most common method of satisfying the statute is where the obligation is offered for sale or resale only outside the United States and its possessions, and is not required to be registered under the Securities Act of 1933 because it is intended for distribution to persons who are not U.S. persons. Prior to the issuance of the obligations, the issuer, in reliance on written opinion of counsel, must have made a good faith determination that the obligations need not be registered under the Securities Act of 1933 because they are intended for distribution to non-U.S. persons. Temp. Treas. Reg. § 1.163-5(c)T(2)(i)(A). Two other methods of satisfying the first requirement of I.R.C. § 163(f)(2)(B) are (1) the use of covenants by the underwriters and confirmations by the purchaser, physical delivery on presentation of a certificate and no actual knowledge that the certificate is false or (2) issuance outside the United States by an issuer that is not significantly engaged in interstate commerce where issuance occurs through a branch located abroad in an active banking business. Temp. Treas. Reg. § 1.163-5(c)T(2)(i)(B) and (C).

The second requirement of I.R.C. § 163(f)(2)(B), that interest be payable only outside of the United States and its possessions, is satisfied where payment of such interest can be made only upon presentation of a coupon or upon demand for payment outside of the United States and its possessions. Temp. Treas. Reg. § 1.163-5(c)T(2)(v). Payments of interest by transfer into an account maintained by the payee in the United States or mailed to a U.S. address will not qualify if the interest is paid on an obligation issued by a U.S. person or certain other issuers. *Id.* Cf. Temp. Treas. Reg. § 35a.9999-5(a), Q&A-2 and -5, which make a similar requirement in order to avoid backup withholding. *See infra* note 83.

Payment may be made to the account of a financial institution in the United States, however, if the payment is merely a step in the clearance of funds and if the payment is promptly credited to an

The term "portfolio interest" also includes interest paid on an obligation in registered form⁶³ where the United States payor has received a statement that the beneficial owner of the obligations is not a United States person.⁶⁴ The required statement may be made by the beneficial owner of the obligation, a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of trade or business.⁶⁵

account maintained outside the United States by the financial institution or by the person for which the financial institution collected the interest. Temp. Treas. Reg. § 1.163-5(c)T(2)(v)(B)(2) (T.D. 8046, 50 Fed. Reg. 33,522, *reprinted in* 1985-40 I.R.B. 9).

Interest may be payable at the office of the issuer or its U.S. paying agent, however, if the payment of the full amount of interest at the offices of the foreign paying agent becomes illegal or is effectively precluded due to the imposition of exchange controls. Temp. Treas. Reg. § 1.163-5(c)T(2)(v)(B)(2).

In order to satisfy the third requirement of I.R.C. § 163(f)(2)(B), a bearer obligation must bear the following legend on the face of the obligation and on any interest coupons which may be detached therefrom:

Any United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in Sections 165(f) and 1287(a) of the Internal Revenue Code.

Temp. Treas. Reg. § 1.163-5(c)T(1)(ii)(B). *See infra* note 89 for a discussion of these sanctions on U.S. persons. A bearer bond may be exempt from the third requirement, however, if the obligation meets the interstate commerce exception or is represented by a temporary global security. Temp. Treas. Reg. § 1.163-5(c)T(1)(ii)(B).

⁶³ For purposes of the repeal legislation, the term "registered form" has the same meaning given such term in § 163(f). I.R.C. §§ 871(h)(6) and 881(c)(6).

An obligation is in "registered form" if (1) 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 (2) the right to the principal of, and stated interest on, the obligation may be transferred only through a book-entry system. Treas. Reg. §§ 5f.163-1(a) and 5f.103-1(c)(1).

An obligation is considered transferable through a book-entry system if the ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an interest in the obligation. Treas. Reg. § 5f.103-1(c)(2).

An obligation is not considered to be in registered form, however, if it may be converted into bearer form. Temp. Treas. Reg. § 1.165-12T(b)(1). *See also* Temp. Treas. Reg. § 35a.9999-5(c), Q&A-18.

⁶⁴ I.R.C. §§ 871(h)(2)(B) and 881(c)(2)(B). In order to qualify as "portfolio interest," the regulations add to the statutory language the requirement that the obligation be "registration-required" within the meaning of I.R.C. § 163(f)(2)(A). Temp. Treas. Reg. § 35a.9999-5(b), Q&A-8. *See infra* notes 107-24 and accompanying text for a criticism of this requirement.

⁶⁵ I.R.C. § 871(h)(4).

If the initial purchaser is an individual, the required statement must be signed by the beneficial owner under penalties of perjury certifying that such owner is not a U.S. person and providing the name and address of the beneficial owner. Form W-8, or a substantially similar form, must be used for this purpose. The withholding agent must receive the statement in the year in which interest is paid or in either of the two preceeding years and must retain the statement for at least four years. Temp. Treas. Reg. § 35a.9999-5(b), Q&A-9.

If the initial purchaser is a custodian (i.e., a securities clearing organization, bank or other

Interest will not be “portfolio interest,” and therefore will not be exempt, if:

- (1) the recipient owns, directly or indirectly, ten percent or more of the payor;⁶⁶ or
- (2) the recipient is a controlled foreign corporation⁶⁷ and the interest is paid by a related person;⁶⁸ or
- (3) the interest is received by a foreign bank on an extension of credit made pursuant to a loan entered into in the ordinary course of business, unless the interest is received on an obligation of the United States;⁶⁹ or
- (4) the interest received is effectively connected with the conduct of a United States trade or business.⁷⁰

A withholding agent has an explicit duty to withhold only if the agent knows, or has reason to know, that the interest is subject to the tax because it is not “portfolio interest.”⁷¹

financial institution that holds customers’ securities in the ordinary course of its trade or business), the statement, signed under penalties of perjury by an authorized representative of the custodian institution must state that the institution has received a Form W-8 or similar form from the beneficial owner or from another financial institution which received the statement from the beneficial owner. *Id.*

With two exceptions, discussed at Temp. Treas. Reg. § 35a.9999-5(b), Q&A-10, a withholding agent must withhold tax under I.R.C. §§ 1441(a) and 1442(a) if the required statement is not received, even if the interest otherwise qualifies as “portfolio interest.” *Id.*

⁶⁶ I.R.C. §§ 871(h)(3) and 881(c)(3)(B). See *supra* note 51; see also *infra* note 74.

⁶⁷ See *supra* note 52 for the definition of a CFC.

⁶⁸ I.R.C. § 881(c)(3)(C). The legislation as enacted differs from the Senate provision by exempting interest paid to a CFC (if otherwise eligible for the exemption) unless paid by a “related person” (as defined in I.R.C. § 864(d)(4)). EXPLANATION OF THE 1984 ACT, *supra* note 6, at 395-96.

A “related person” under I.R.C. § 864(d)(4) means (A) any person who is a related person (within the meaning of I.R.C. § 267(b)), and (B) any U.S. shareholder (defined in I.R.C. § 951(b)) and any person who is a related person (within the meaning of I.R.C. § 267(b)) to a U.S. shareholder. This definition is quite broad.

Under I.R.C. § 881(c)(4), where portfolio interest is received by a CFC from other than a related person, the following subpart F relief provisions will not apply:

(1) I.R.C. § 954(b)(3)-exception where foreign base company income is less than 10%; (2) I.R.C. § 954(b)(4)-exception where CFC not formed or availed of to avoid tax; and (3) exceptions to the foreign personal holding company income rules in I.R.C. § 954(c), including (a) I.R.C. § 954(c)(3)(B)-exception for certain income derived in the active conduct of a trade or business; (b) I.R.C. § 954(c)(3)(C)-exception for certain income derived from an insurance company; and (c) I.R.C. § 954(c)(4)(A) and (B)-exception for certain income received from related persons. This provision ensures that such interest will be taxed currently to the CFC’s U.S. shareholders. In addition, under new I.R.C. § 904(g), such income will retain its source as U.S. source income. Also, any foreign taxes imposed on such income may be subject to a separate foreign tax credit limitation under new I.R.C. § 904(d).

⁶⁹ I.R.C. § 881(c)(3)(A). See *infra* note 74.

⁷⁰ See *supra* note 13.

⁷¹ Such duty would arise where the withholding agent knows, or has reason to know that the recipient “is a controlled foreign corporation related to the payor, has a direct ownership interest in the U.S. payor, or (except in the case of interest paid on an obligation to the United States) is a bank and the interest is received on an extension of credit made pursuant to a loan agreement entered into

Notwithstanding the allowance of bearer obligations, the Secretary of the Treasury is empowered to require registration of obligations⁷² and to remove the exemption with respect to residents of a foreign country where he deems the exchange of information between the United States and that country inadequate.⁷³ Moreover, the conference report authorizes and encourages the Secretary to examine and prohibit "back-to-back" loans, transactions which attempt to circumvent the restrictions on ten percent owners and on foreign banks by interposing unrelated parties.⁷⁴

In order to resolve the issues raised by the Service in audits of finance subsidiaries, namely whether or not the subsidiary was valid and effective for tax purposes,⁷⁵ Congress provided that finance subsidiaries in existence on the date of enactment would be recognized as valid corporations and that the finance subsidiary's Eurobond obligations would be treated as its own obligations and not those of its domestic parent.⁷⁶

in the ordinary course of the bank's business." EXPLANATION OF THE 1984 ACT, *supra* note 6, at 397. See I.R.C. § 1441(c)(9), which provides:

In the case of portfolio interest (within the meaning of [section] 871(h)(2)) no tax shall be required to be deducted and withheld from such interest unless the person required to deduct and withhold tax from such interest knows, or has reason to know, that such interest is not portfolio interest by reason of section 871(h)(3).

⁷² § 127(f) of the 1984 Act amended I.R.C. § 163(f)(2)(C)(i) to provide that the Secretary may require registration of bearer obligations. Prior to the amendment, the Secretary could require registration of bearer obligations only where such obligations were determined to be used frequently in avoiding federal taxes.

⁷³ I.R.C. §§ 871(h)(5) and 881(c)(5); see *supra* note 55.

⁷⁴ In a back-to-back loan, a foreign affiliate of a U.S. taxpayer or a foreign bank lends money to an unrelated foreign party which then relends the money at a discount to the U.S. taxpayer. EXPLANATION OF THE 1984 ACT, *supra* note 6, at 395.

⁷⁵ See *supra* note 36.

⁷⁶ Section 127(g)(3) of the 1984 Act; EXPLANATION OF THE 1984 ACT, *supra* note 6, at 397-98. Specifically, if certain requirements are met, interest paid to the foreign finance subsidiary will be treated as paid to a resident of the country in which the CFC is incorporated. The requirements are (1) that the CFC was in existence on or before June 22, 1984; (2) that the principal purpose of the CFC on the date of the interest payment was issuing its obligations, holding short-term obligations and lending proceeds of such obligations to affiliates (*i.e.*, persons related to it under I.R.C. § 482); (3) that the obligations on which interest is paid are obligations of a U.S. affiliate that were issued before June 22, 1984 and (4) that on the date on which interest is paid, the payee satisfies the requirements included in four revenue rulings: Rev. Rul. 69-377, 1969-2 C.B. 231; Rev. Rul. 69-501, 1969-2 C.B. 233; Rev. Rul. 70-645, 1970-2 C.B. 273; and Rev. Rul. 73-110, 1973-1 C.B. 454. Sections 127(g)(3) and 121(b)(2)(D) of the 1984 Act. Although other requirements are listed in these rulings, the thrust of the rulings is that the debt-to-equity ratio of the finance subsidiary at all times must not exceed 5:1. See *supra* note 22.

This provision, "grandfathering" certain finance subsidiary's obligations outstanding on June 22, 1984, is contained in sec. 127(g)(3) of the 1984 Act and amends I.R.C. § 881 in a non-code provision. By grandfathering issues in existence on June 22, 1984 and by setting the effective date of the legislation at the date of enactment (July 18, 1984), however, Congress inadvertently left open a "window period" for issues floated between those two dates. See *infra* notes 125-47 and accompanying text. For examples of private letter rulings applying the grandfathering rule of Act sec.

Portfolio obligations whose interest is exempt from withholding are also exempt from United States estate tax if held by a nonresident at death.⁷⁷

B. Compliance Issues and Concerns Over Tax Evasion

The Eurobond market is largely composed of bearer obligations because of foreigners' demand for anonymity.⁷⁸ Throughout the congressional hearings on the repeal legislation, concerns were voiced over the possibility of increased tax evasion by United States citizens through the use of such bearer obligations.⁷⁹ The inclusion of safeguards to thwart such evasion, along with assurances by the Treasury to monitor and report to Congress on compliance with the Act's provisions, however, apparently satisfied enough of the legislators to allow passage of the measure.⁸⁰ Yet, even though the repeal legislation had passed, regulations in existence on the date of enactment effectively precluded direct issuance of bearer debt because such regulations required "backup withholding" of twenty percent unless the foreign person provided his name and address to the Treasury.⁸¹ Thus, direct Eurobond issues were fore-

127(g)(3), see L.T.R. 8527010 (Mar. 22, 1985) and L.T.R. 8530002 (Apr. 16, 1985); see also L.T.R. 8449060 (Sept. 6, 1984).

⁷⁷ I.R.C. § 2105(b)(3) provides that such obligations constitute property not within the United States for estate tax purposes. Accordingly, such obligations are not included in the decedent's gross estate under I.R.C. § 2103 and are not subject to estate tax under I.R.C. § 2101.

⁷⁸ Demands for anonymity do not necessarily reflect tax-evasion motives. Many foreigners, especially citizens of politically unstable countries, seek anonymity because of fear of confiscation of assets. *May 1, 1984 Hearings, supra* note 3, at 253.

⁷⁹ See *infra* notes 174-82 and accompanying text.

⁸⁰ During the 1984 hearings, the Treasury stated its belief that the regulations, enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) to discourage the holding of bearer bonds by U.S. persons, would be effective in coping with any tax evasion problems associated with the repeal legislation. See *infra* note 109 and text accompanying note 176. The treasury regulations issued on August 17, 1984 on the repeal legislation were based on the safeguards contained in the TEFRA regulations. Furthermore, then-Treasury Secretary Regan promised that the Treasury would monitor compliance and report to Congress on the effect of the regulations within 90 days of the first interest payment on a "foreign-targeted" issue of Treasury securities.

⁸¹ "Backup withholding" refers to a method that Congress adopted in the Interest and Dividend Tax Act of 1983, Pub. L. No. 98-67, 97 Stat. 369, to deal with taxpayer failure to submit certification statements and to report other information such as taxpayer identification numbers. Unless taxpayers comply with such requirements by furnishing certification statements or identification numbers where required, the payor of the interest is required to withhold at a rate of 20% of the payment. I.R.C. § 3406(a). The backup withholding system of I.R.C. § 3406 applies only to "reportable payments" made after 1983 to payees who have failed to furnish the required reporting information.

Generally, "reportable payments" subject to backup withholding include payments of principal or interest on an obligation if such payments are required to be reported on an information return under I.R.C. §§ 6045 (principal) or 6049(a) (interest). I.R.C. §§ 3406(b)(2)(A)(i) and (3)(C).

Under I.R.C. § 6049(a), any person who makes payments of interest aggregating \$10 or more during a calendar year, or who collects interest as a nominee and makes such payments, is subject to

stalled until August 22, 1984 when, under great pressure from Congress, United States corporate executives and investment bankers, Treasury issued temporary regulations on the repeal legislation.⁸²

an information reporting obligation. For purposes of I.R.C. § 6049, "interest" includes, among other things, interest on an obligation in registered form or of a type offered to the public, I.R.C. § 6049(b)(1)(A), but does not include interest on amounts subject to withholding under I.R.C. §§ 1441 or 1442 or amounts which would have been subject to those sections but for the fact that (a) such income is from foreign sources; or (b) the payor is exempt from I.R.C. § 1441(a) by reason of I.R.C. § 1441(c) or a tax treaty. I.R.C. §§ 6049(b)(2)(C)(ii) and 6049(b)(5). Moreover, Treas. Reg. § 1.6049-5(b)(1)(vi)(B)(3) requires that the payment be exempt from I.R.C. § 1441(a) not only under I.R.C. § 1441(c), but also under paragraph (a) or (f) of Treas. Reg. § 1.1441-4.

Prior to the 1984 Act, interest paid to foreign investors through international finance subsidiaries was exempt from information reporting under I.R.C. § 6049 since it was from foreign sources and, therefore, was not "interest" as defined therein. Accordingly, under I.R.C. § 3406(b)(2)(A)(i), such payments were also exempt from backup withholding since they were not "reportable payments." Payments of principal to foreign investors through international finance subsidiaries were exempt from information reporting and backup withholding under I.R.C. § 6045(a) and Treas. Reg. §§ 35a.9999-3A and 35a.9999-3, Q&A-37.

The repeal legislation amended the relevant Code sections in order to permit direct issuances of Eurobonds by U.S. companies. However, prior to amendment of the existing regulations, two provisions therein would have subjected payments of principal and interest to information reporting and backup withholding, thus preventing companies from utilizing the repeal legislation until the amendment of the regulations.

The first problem with the existing regulations was that interest payments paid by U.S. companies would be considered "interest" under I.R.C. § 6049 since those payments were neither foreign source income nor were they exempt from I.R.C. § 1441(a) under paragraph (a) or (f) of § 1.1441-4. (While the addition of I.R.C. § 1441(c)(9) satisfied the Code's requirements under § 6049, it did not satisfy those of the Treas. Reg. § 1.6049-5(b)(1)(vi)(B)(3)). As the interest payments would have been subject to information reporting under I.R.C. § 6049, they would have also been subject to backup withholding under I.R.C. § 3406.

The second problem arose on the issuance of Temp. Treas. Regs. § 35a.9999-5 where, to the dismay of many tax practitioners, the Service took the position that principal payments on bearer and foreign-targeted registered obligations were "reportable payments" (and therefore subject to information reporting) under I.R.C. § 6045 where such payments were made by dual custodians. Temp. Treas. Reg. § 35a.9999-5, Q&A-7 and -17. Such payments would also have been subject to backup withholding under I.R.C. § 3406. Payments of interest and principal on registered obligations were not subject to information reporting and backup withholding under existing regulations, since the payee's name and identity were disclosed. The use of registered obligations, however, was inconsistent with the concept of investor anonymity associated with bearer obligations and such a requirement thus threatened to halt activity in the Eurobond market. 23 TAX NOTES 742 (May 14, 1984) and 24 TAX NOTES 7 (Jul. 2, 1984). See also *Repeal of the Withholding Tax*, *supra* note 5, at 51.

In response to the two problems in the regulations, the Service promptly issued new regulations which (1) exempted payments of portfolio interest from information reporting and backup withholding and (2) exempted principal payments from backup withholding. However, these regulations retained the information reporting requirements with respect to principal payments by dual custodians unless such custodians have documentary evidence that the payee is not a U.S. person. See *infra* note 83.

⁸² The new temporary regulations exempt, from information reporting and backup withholding, interest and principal payments made by U.S. issuers or their agents on the three types of obligations where interest paid thereon qualifies for portfolio interest within the meaning of I.R.C. §§ 871(h)(2) or 881(c)(2). Temp. Treas. Reg. § 35a.9999-5 (T.D. 7967, 49 Fed. Reg. 33,239, *reprinted in* 1984-2

The temporary regulations generally exempt, from information reporting and backup withholding procedures, interest and principal payments made by United States corporate issuers or their agents on obligations in bearer,⁸³ foreign-targeted registered⁸⁴ and foreign non-targeted registered form,⁸⁵ as long as the payor does not have actual

C.B. 38) deals with the application of backup withholding and information reporting under the repeal legislation. Temp. Treas. Reg. § 35a.9999-4T (T.D. 7966, 49 Fed. Reg. 33,228, *reprinted in* 1984-2 C.B. 324, amended by T.D. 7972, 49 Fed. Reg. 34,340, *reprinted in* 1984-2 C.B. 327) deals with payments made by U.S. and foreign banks and brokers. For a thorough analysis of these regulations, see *U.S. Income Withholding Tax—Foreign Persons*, 341 TAX MGM'T PORTFOLIO (BNA) A-20 to -20(6).

⁸³ As to obligations issued in bearer form, where interest and principal are paid by the company or its paying agent outside the United States, no information reporting or backup withholding is required unless the issuer or its agent has actual knowledge that the payee is a U.S. person. Temp. Treas. Reg. § 35a.9999-5(a), Q&A-2, -7. Whether a payment of interest is made outside the United States is determined under Temp. Treas. Reg. § 35a.9999-3, Q&A-37, but in no case will interest be considered to be paid outside the United States if it is paid to a U.S. address, whether by mail or electronic transfer. *Id.* See also Temp. Treas. Reg. § 35a.9999-5(a), Q&A-3 through -6.

Payments of interest made outside the United States by a custodian, nominee or other agent of the payee with respect to such payment are generally not subject to information reporting under I.R.C. § 6049. Temp. Treas. Reg. § 35a.9999-4T, Q&A-5(ii). Such payments are therefore not subject to backup withholding under I.R.C. § 3406. *Id.* at Q&A-5(iv). The same rules apply to payments of principal and proceeds of sale. *Id.* at Q&A-5(v) and Q&A-2.

Payments made by dual custodians (*i.e.*, foreign branches of U.S. banks or brokers, CFC's or a foreign person 50% or more of whose income over a three-year period was effectively connected with a United States trade or business) are not subject to backup withholding. Temp. Treas. Reg. § 35a.9999-4T, Q&A-5(iv). The payments will, however, be subject to information reporting under I.R.C. § 6049 unless the custodian has documentary evidence in its files that the customer either is not a U.S. person or is otherwise exempt. Documentary evidence necessary to satisfy this requirement is defined at Temp. Treas. Reg. § 35a.9999-4T, Q&A-5(iii).

Finally, payments of principal and interest by a United States custodian, nominee or other agent will be exempt from information reporting and backup withholding only if the custodian receives a statement signed under penalties of perjury that the beneficial owner is not a U.S. person. Temp. Treas. Reg. § 35a.9999-4T, Q&A-3.

The question of the application of backup withholding to dual status custodians is still under consideration by the Treasury; withholding may be imposed in the future on such custodians on a prospective basis only. *Id.* at Q&A-5(iv).

⁸⁴ As to foreign-targeted registered obligations, *see infra* note 98, payments of principal and interest are exempt from backup withholding and information reporting where the registered owner (if it is outside the United States and is a financial institution holding customers' securities in the ordinary course of business) certifies to the payor as to each payment that the beneficial owner is not a U.S. person. Moreover, the payor must not have actual knowledge that the beneficial owner is a U.S. person. The beneficial owner's identity, however, need not be disclosed. Temp. Treas. Reg. § 35a.9999-5(b), Q&A-12 to -17, *as amended* by T.D. 8046, 50 Fed. Reg. 33,522, *reprinted in* 1985-40 I.R.B. 9.

Where the payment is made by a dual custodian, such payments are subject to information reporting unless the custodian has documentary evidence in its files that the payee is not a U.S. person. *Id.* at Q&A-16, Temp. Treas. Reg. § 35a.9999-4T, Q&A-5.

⁸⁵ Payments of portfolio interest on foreign non-targeted registered obligations will be exempt from backup withholding and information reporting only if the payee provides a W-8 or substitute

knowledge that the payee is a United States person.⁸⁶ The regulations distinguish between payments made by foreign offices of foreign financial institutions and those made by foreign offices of United States financial institutions, (dual custodians); the former are exempt from both information reporting and backup withholding requirements, while the latter are subject to information reporting requirements, but are currently exempt from backup withholding.⁸⁷ Many securities officials have balked at the requirements established by the regulations, claiming that they are onerous and that compliance with them will prove costly.⁸⁸

A separate set of temporary regulations, also issued on August 22, 1984, describes sanctions on issuers and holders of "registration-required" obligations which are not in registered form.⁸⁹ Significantly, these regulations delete a prior provision which allowed United States

form to the payor and the payor does not have actual knowledge that the payee is a U.S. person. Temp. Treas. Reg. § 35a.9999-5(b), Q&A-9 to -11.

Payments of principal on a registered obligation by a paying agent are exempt from backup withholding if the payor receives a statement described in Treas. Reg. § 1.6045-1(g)(1). Temp. Treas. Reg. § 35a.9999-1, Q&A -55. As to foreign and dual status custodians, such payments will be exempt from information reporting if the statement described in Treas. Reg. § 1.6045-1(g)(1) is received. However, such payments will not be subject to backup withholding. Temp. Treas. Reg. § 35a.9999-4T, Q&A-1, -2.

⁸⁶ See *supra* notes 82-85.

⁸⁷ *Id.*

⁸⁸ Temp. Treas. Reg. §§ 1.163-5(c)T(2) and 35a.9999-4T and -5 impose many restrictions on issuers of bearer obligations and on foreign offices and subsidiaries of U.S. banks. In order to qualify as "portfolio interest" and to avoid the imposition of sanctions, backup withholding and information reporting, these parties must obtain documentation that the payee is not a U.S. person and must send confirmations to the purchaser stating that the purchaser must represent the same. Critics state that these requirements are costly and inefficient and that they will put U.S. branches of banks at a disadvantage relative to their foreign counterparts, who are not subject to such requirements. Letter from John Rolf III of Citibank, New York to the Treasury, contained in 25 TAX NOTES 764 (Nov. 26, 1984); Letter from the Securities Industry Association to the Treasury, 25 TAX NOTES 610 (Nov. 12, 1984).

⁸⁹ An issuer of a registration-required obligation that is not in registered form (which mainly includes bearer obligations which fail to meet the requirements of I.R.C. § 163(f)(2)(B) and the regulations issued thereunder) will be subject to "issuer sanctions." These sanctions include: (1) denial of interest deductions on such obligations, I.R.C. § 163(f)(1) and Treas. Reg. § 1.163-5; (2) imposition of an excise tax of 1% of the principal amount of such obligations multiplied by the number of calendar years the obligations will be outstanding, I.R.C. § 4701(a); and (3) denial of an earnings and profit adjustment under I.R.C. § 312(m).

U.S. holders of a registration-required obligation not in registered form are subject to statutory "holder sanctions" including: (1) denial of capital gain treatment upon the sale of the obligation at a gain, I.R.C. § 165(j) and Treas. Reg. § 1.165-12T; (2) denial of loss deduction upon the sale of the obligation at a loss, I.R.C. § 1287(a) and Treas. Reg. § 1.1287-1T; and (3) denial of the exemption for interest income under I.R.C. § 103(j). An exception to the sanctions exists if the U.S. person holds such obligation through a financial institution that reports any interest collected on behalf of its customers to the Service. The holder must establish a reporting relationship with a financial institution within 30 days of the date of purchase of the bearer obligation. Treas. Reg. §§ 1.165-12T(c)(1) and 1.1287-1T(c).

firms to sell a portion of a registered issue in the United States in a form that could later be converted for foreign sale as bearer debt.⁹⁰ Thus, instead of being able to issue one security that could be bought and sold in both the United States and abroad, a firm must now issue two separate types of securities. Officials in the securities industry contend that this regulation will severely hamper the creation of a secondary market for bearer Eurobond debt and the development of a truly integrated market.⁹¹ These individuals (and their tax advisors) further believe that the regulations place restrictions on the raising of foreign capital which Congress did not intend when it approved the repeal legislation.⁹² Conversion restrictions and certification requiring the disclosure of the investor's identity on registered obligations are two areas in which critics contend that the Service has effectively "legislated" the rules, and in so doing, has restricted the broad repeal which Congress enacted.

*C. Prohibition on Issuance of Bearer Debt
by the Federal Government and its Agencies*

From a marketing standpoint, the most attractive Eurobond obligation is bearer debt. As noted above, however, these obligations are thought to carry with them a higher potential for tax evasion.⁹³ Thus, certain members of Congress feared that the Treasury, a driving force behind the repeal legislation, might attempt to issue bearer debt in its efforts to fund the national deficit at a cheaper cost.⁹⁴ To these individuals, the federal government was essentially condoning tax evasion by its issuance of bearer debt. After informal meetings and correspondence be-

⁹⁰ Prop. Treas. Reg. § 1.163-5(c)T(2)(vi), (issued Sept. 1983) described the conditions under which a registered obligation could be converted to bearer form. T.D. 7965, containing the § 163 regulations which superceded Prop. Treas. Reg. § 1.163-5, deleted this provision "because of concern that this conversion rule would have created a substantial market of bearer paper that would be more readily available to U.S. persons." An obligation will not be considered to be in registered form if, under any circumstances, it can be converted into bearer form. Temp. Treas. Reg. § 1.163-5(c)T(1); see also Temp. Treas. Reg. § 1.165-12T(b)(1).

⁹¹ 164 DAILY REP. FOR EXECUTIVES (BNA), K-1 (Aug. 23, 1984). Once again, however, a faction developed in the securities industry. While other firms claimed that this restriction would thwart the integration of the market, First Boston and Morgan Stanley supported the nonconvertibility decision. In a letter to Treasury Secretary Regan, the Co-Chairman of First Boston stated that (1) the rule has had no adverse impact to date and (2) continued agitation by the securities industry may cause a congressional backlash which might result in the removal of the benefits of the repeal legislation. Letter from Yves-Andre Istel to Treasury Secretary Regan, contained in 25 TAX NOTES 1120 (Dec. 17, 1984).

⁹² Critics from the securities industry voiced their objections to these regulations at the January 28, 1985 hearings on the regulations. See 26 TAX NOTES 404 (Feb. 4, 1985) for a summary of these proceedings.

⁹³ See *infra* note 174 and accompanying text.

⁹⁴ 24 TAX NOTES 325 (Jul. 23, 1984) (remarks of spokesman for Rep. Doug Barnard).

tween Congress and the Treasury, and concurrent with the proposal of a "sense of the Senate" resolution prohibiting such issuance of bearer debt by the Treasury, then-Secretary Donald Regan made assurances to Congress on August 16, 1984, that Treasury debt would not be sold to foreigners in bearer form.⁹⁵ The regulations issued on August 22, 1984 then extended this restriction on issuance of bearer obligations to government-owned or sponsored agencies.⁹⁶ Finally, on September 7, 1984, Regan announced that the restriction would also apply to any security in which "more than 50% of the income, or collateral, supporting the instrument consists of income or principal of a U.S. Government security."⁹⁷

Refusing to permit the issuance of government obligations in bearer form, Treasury created the foreign-targeted registered obligation.⁹⁸ Although securities experts initially viewed the prospect of success in

⁹⁵ Statement of former Treasury Secretary Donald Regan, *reported in* 24 TAX NOTES 734 (Aug. 20, 1984); *see infra* note 98. The "sense of the Senate" resolution appears at 130 CONG. REC. S10,448 (daily ed. Aug. 10, 1984).

⁹⁶ Temp. Treas. Reg. § 1.163-5(c)(1).

⁹⁷ Treas. News Release 2835 (Sept. 7, 1984), *reprinted at* 84-10 CCH ¶ 6871; Treas. News Release 2847 (Sept. 9, 1984), *reprinted at* 84-10 CCH ¶ 6872. The Secretary of the Treasury is granted authority under I.R.C. § 163(f)(2)(C)(i) to specify by regulation which obligations are not eligible for the foreign-targeted exception to the registration rules. In essence, the Secretary has the power to require registration of obligations that would otherwise be eligible for issuance as bearer obligations. Pursuant to such authority, the Treasury will be issuing regulations implementing this provision. Obligations which may not be issued in bearer form will include securities issued by government agencies and other securities in which "more than 50% of the income, or collateral, supporting the instrument consists of income or principal of a U.S. Government security." 24 TAX NOTES 1110 (Sept. 17, 1984). This restriction is aimed at thwarting attempts made by investment houses and other financial institutions to repackage Treasury obligations in a form eligible for issuance in bearer form. Prior to notice of the regulations, however, Salomon Bros. sold a \$7 billion issue of Certificates of Accrual on Treasury Securities (CATS), bearer securities backed by Treasury obligations. *Id.* at 1103-04. These obligations, grandfathered by the effective date stated in the Treasury Release (Sept. 7, if the obligations are issued by Sept. 21, 1984), will be unique in the market since Treasury has denied eligibility for the use of bearer form to later issuances of such securities. 24 TAX NOTES 1226 (Sept. 24, 1984). For an example of a ruling applying the Sept. 7, 1984 grandfather date, see L.T.R. 8506120 (Nov. 20, 1984). Additionally, on Sept. 26, 1984, Rep. Marty Russo introduced a bill, H.R. 6315, which would impose withholding on anyone who repackages U.S. government debt for resale in bearer form. 130 CONG. REC. H10,365 (daily ed. Sept. 26, 1984).

⁹⁸ Treasury adopted the "foreign-targeted" registered security because of concerns over tax evasion on bearer bonds. These securities, which are registered in street name and targeted to foreign purchasers, feature an annual coupon (familiar to Europeans) and use a special certification so that the beneficial owner need only state that he is not a citizen or resident of the U.S. The beneficial owner need not, however, reveal his identity so long as the registered owner is a financial institution. Temp. Treas. Reg. § 35a.9999-5(b), Q&A-12 to -17, *as amended by* T.D. 8046, 50 Fed. Reg. 33,522, *reprinted in* 1985-40 I.R.B. 9. This certification must be made at issuance and prior to each interest payment. For 45 days after the initial issuance of the obligations, they may not be resold in the U.S. market. Bids for the securities are accepted only by the Federal Reserve Bank in New York and only from overseas institutions (including foreign branches of U.S. institutions). Finally, bidders must certify that, as of the date of issuance, the notes are not being acquired for, or for resale to, a U.S. person. Treasury Announcement, *reported in* 24 TAX NOTES 1110 (Sept. 17, 1984).

marketing Treasury debt in foreign-targeted registered form as dismal, such predictions have not been accurate: two offerings of these treasury securities made subsequent to the passage of the repeal legislation have been substantially overbid by foreign purchasers.⁹⁹

Government agencies such as the Federal National Mortgage Association and the Federal Home Loan Bank had hoped to capitalize on the lower interest rates available through the issuance of tax-free bearer securities in the Eurobond market. Since the new regulations prohibited the agencies from issuing debt in bearer form, however, they were forced to use foreign-targeted registered form, generally thought to be less attractive in the Eurobond market.¹⁰⁰ These agencies, in an effort to raise cheaper funds to finance the housing industry, also sought to issue non-governmental mortgage pass-through certificates in bearer form to foreigners.¹⁰¹ The temporary regulations, however, initially took the position that such obligations were not exempt from the thirty percent withholding tax because the underlying securities were not "registration-required" obligations under I.R.C. § 163(f)(2)(A).¹⁰² Commentators ar-

⁹⁹ Some securities experts believed that the failure of the Treasury to market bearer obligations, combined with the method of sale used (*i.e.*, auction versus the use of dealer/brokers) would result in a very low demand for the issues. These persons noted that up to 80% of the demand for the first issuance of Treasury obligations (made on October 24, 1984) would be politically-based. *BUS. WK.*, Oct. 22, 1984, at 129.

The October 24, 1984 auction of \$1 billion in 3-year, 11-month notes was successful, with bids outnumbering issuances by 4 to 1. Due to the annual interest payment feature, Treasury estimates that it will save \$3.2 million in interest over the life of the bonds. *Wall St. J.*, Oct. 28, 1984, at 16, col. 1. The second auction, on November 28, 1984, featured \$1 billion of 5-year, 2-month 11% Series H notes. Bids tendered for this issue amounted to \$2.1 billion. 25 *TAX NOTES* 1095 (Dec. 17, 1984).

¹⁰⁰ Obligations issued in bearer form by a governmental agency are not considered to have been issued pursuant to arrangements reasonably designed to ensure sale to non-U.S. persons. Temp. Reg. § 1.163-5(c)(1). On November 7, 1984, Fannie Mae announced that it would sell \$300 million of 7-year, 11.5% debentures in foreign-targeted registered form. This compares with a \$500 million domestic issue made in October 1984 at 12.15%. 217 *DAILY REP. FOR EXECUTIVES* (BNA) G-1 (Nov. 8, 1984).

¹⁰¹ Mortgage pass-through certificates are bonds whose underlying securities are a pool of real estate mortgages held by a trust. Letter from Lawrence D. Fink of First Boston Corp. to the Treasury, contained in 25 *TAX NOTES* 611 (Nov. 12, 1984).

¹⁰² Temp. Treas. Reg. § 35a.9999-5, Q&A-1 and -8 state that for a bearer obligation to be a portfolio debt instrument which qualifies for repeal of the withholding, the obligation must "be a registration-required obligation within the meaning of I.R.C. § 163(f)(2)(A) but for the fact that it is described in I.R.C. § 163(f)(2)(B)." In other words, bearer bonds issued under the "foreign-targeted" exception rules of I.R.C. § 163(f)(2)(B) qualify for exclusion from registration requirements, but the remaining I.R.C. § 163(f)(2)(A) obligations do not because they are not considered "registration-required." These latter issues include debt obligations (1) issued by a natural person; (2) of a type not offered to the public; or (3) with maturities of not more than one year. Interest paid on these obligations "is not portfolio interest." Temp. Treas. Reg. § 35a.9999-5, A-1, -8. See *infra* notes 108-09. Mortgage pass-through certificates were originally excluded from the repeal legisla-

gued, however, that the Service's exclusion of mortgage pass-through certificates from the benefits of the repeal legislation was inconsistent with both congressional intent and with the statutory language of the 1984 Act.¹⁰³ The critics' arguments ultimately persuaded the Treasury Department: on August 20, 1985, Treasury issued temporary regulations which provide that such obligations will be considered "registration-required" within the meaning of I.R.C. § 163(f)(2)(A) without regard to the status of the underlying obligations.¹⁰⁴ Accordingly, interest payable on mortgage pass-through certificates will now qualify for the repeal legislation, since that interest is considered "portfolio interest."¹⁰⁵ One un-

tion because the underlying obligations for such certificates are generally obligations of homeowners, i.e., "natural persons."

¹⁰³ Experts in the foreign-taxation field note that Congress, in enacting sec. 127 of the 1984 Act, referred only to the requirements of I.R.C. § 163(f)(2)(B) in defining portfolio interest. The language of the statute, they argue, does not refer to I.R.C. § 162(f)(2)(A), nor does the legislative history indicate that Congress intended to exclude obligations described therein. See *infra* note 114 and accompanying text. Moreover, on December 31, 1984, the Joint Committee on Taxation released the EXPLANATION OF THE 1984 ACT, *supra* note 6, which generally indicates the Congressional intent behind the provisions of the 1984 Act. The publication states, "Congress intended that interest . . . on publicly-traded mortgage pass-through securities be eligible for the exemption from the 30% tax. Congress considers these securities to be registration-required under the TEFRA compliance rules." *Id.* at 396.

The Service's interpretation on mortgage pass-through securities was opposed by the Public Securities Association, the Savings Institute, First Boston, Fannie Mae, the American Bankers Association, The American Bar Association, and the National Association of Realtors, which called the Treasury's interpretation "discriminatory" because, they argued, it would result in higher mortgage rates and fewer home purchases. 25 TAX NOTES 1190 (Dec. 24, 1984) and 25 TAX NOTES 1066 (Dec. 17, 1984).

Reps. Gibbons and Conable, authors of one version of the repeal legislation, wrote the Treasury to voice their disagreement with the Treasury's interpretation, noting that the repeal legislation was intended to benefit the housing finance industry. 25 TAX NOTES 406 (Oct. 29, 1984) and 25 TAX NOTES 1065 (Dec. 17, 1984).

¹⁰⁴ Temp. Treas. Reg. § 1.163-5(d)T (T.D. 8046, 50 Fed. Reg. 33,522, *reprinted in* 1985-40 I.R.B. 9). Pass-through certificates will be considered to be described in I.R.C. § 163(f)(2)(B) (the requirements for obligations issued in bearer form) if the pass-through certificate itself is described in the section, without regard to whether the underlying obligation held by the fund or trust is described in that section. *Id.*

The rules in Temp. Treas. Reg. § 1.163-5(d)T apply for any section that refers to those regulations for the definition of the term "registration-required obligation." *Id.*

In order to deal with potential abuses of the mortgage pass-through certificate provisions, the Commissioner may characterize a certificate in accordance with the substance of the transaction, and may impose the issuer sanctions under I.R.C. §§ 163(f)(1) and 4701. *Id.* Thus, for example, if obligations in registered form are contributed to a trust and bearer certificates in the trust are issued in a form that does not meet the requirements of I.R.C. § 163(f)(2)(B), the obligations will not be considered to be issued in registered form, nor will they meet the requirements of I.R.C. § 163(f)(2)(B). Accordingly, no interest deduction will be allowed and an excise tax will be imposed. *Id.*

¹⁰⁵ Temp. Treas. Reg. § 35a.9999-5(d), Q&A-20 (T.D. 8046, 50 Fed. Reg. 33,522, *reprinted in* 1985-40 I.R.B. 9) provides that interest paid to a holder of a pass-through certificate will qualify as portfolio interest under I.R.C. §§ 871(h)(2) or 881(c)(2) if it is described in A-1 or A-8 of

derwriter reports that "hundreds of millions of dollars" of mortgage-pool securities are currently scheduled to be issued under the new regulations.¹⁰⁶

D. The "Registration-Required Obligation" Rule

Perhaps the most controversial issue surrounding the repeal legislation lies in the Treasury's current interpretation of what types of obligations qualify for the withholding tax exclusion. The Code clearly limits the repeal legislation to "portfolio interest" and defines that term with respect to obligations in both registered and non-registered form.¹⁰⁷ In the temporary treasury regulations, however, the Treasury Department has taken the position that only obligations which are "registration-required" within the meaning of I.R.C. § 163(f)(2)(A) will be eligible for the repeal legislation.¹⁰⁸ This interpretation prevents interest on three categories of obligations from qualifying as "portfolio interest." Those categories are:

- (1) obligations issued by a natural person;
- (2) obligations of a type not offered to the public; and
- (3) obligations with maturities of not more than one year.¹⁰⁹

Treasury's interpretation has far-reaching implications in several ar-

§ 35a.9999-5, without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates is described in A-1 or A-8. However, a certificate issued after July 18, 1984 will qualify under this provision only to the extent that the underlying obligations are issued after that date. *Id.*

¹⁰⁶ *Tax Report*, Wall St. J., Aug. 28, 1985, at 1, col. 5 (statement of Lewis S. Ranieri of Salomon Bros., Inc.).

¹⁰⁷ I.R.C. §§ 871(h)(2)(A) and (B), 881(c)(2)(A) and (B). *See supra* text accompanying notes 61-65.

¹⁰⁸ Temp. Treas. Reg. § 35a.9999-5(a), A-1 provides:

Interest is portfolio interest within the meaning of section 871(h)(2)(A) or section 881(c)(2)(A) only if it is paid with respect to an obligation issued after July 18, 1984, that is in bearer form and if the obligation would be a registration-required obligation within the meaning of section 163(f)(2)(A) but for the fact that it is described in section 163(f)(2)(B). Therefore, interest paid on an obligation issued by a natural person, or an obligation with a maturity at issue of not more than one year, or on an obligation not of a type offered to the public (within the meaning of section 163(f)(2)(A)(ii) and the regulations thereunder) is not portfolio interest.

Temp. Treas. Reg. § 35a.9999-5(b), A-8 imposes similar conditions on obligations issued in registered form.

¹⁰⁹ These categories of obligations are excluded by the regulations' reference to obligations which are registration-required within the meaning of I.R.C. § 163(f)(2)(A). As defined in I.R.C. § 163(f)(2), a "registration-required obligation" includes any obligation *other than* an obligation which (i) is issued by a natural person, (ii) is not of a type offered to the public, (iii) has a maturity (at issue) of not more than one year, or (iv) is described in I.R.C. § 163(f)(2)(B). I.R.C. § 163(f)(2)(B) provides that an obligation is described therein if:

- (i) there are arrangements designed to ensure sales only to non-U.S. persons;
- (ii) interest is payable only outside of the United States and its possessions; and
- (iii) there is a legend on the face of the obligation stating that U.S. persons who hold such obligations will be subject to limitations under U.S. income tax laws.

eas. The first and most devastating effect is that issuers (corporate or otherwise) are now unable to issue Eurobond debt through private-placements since such obligations are "of a type not offered to the public."¹¹⁰

Second, Eurobond obligations of partnerships are probably ineligible for the exclusion from withholding because such obligations are, under an "aggregate" theory of taxation,¹¹¹ merely attributed to the underlying individuals. Thus, large partnerships which might otherwise have obtained financing in the Eurobond market are now precluded from using that option.

Third, the exclusion of obligations with maturities of less than one year from the benefits of the repeal legislation effectively precludes the use of shorter-term obligations and hampers the establishment by companies of certain financing mechanisms, such as revolving underwriting fa-

I.R.C. § 163(f), enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324, 596 was one of several provisions in that Act designed to limit sales of bearer instruments to U.S. persons. Congress had noted that increasing numbers of taxpayers were failing to include the interest income on bearer instruments in their tax returns. Such omission was not difficult since bearer instruments do not name the owner of the obligation. In an attempt to limit the sales of bearer instruments in the United States, Congress provided that U.S. issuers and holders of such obligations would be denied certain tax benefits which would otherwise be available if the obligations had been issued in registered form. Thus, I.R.C. § 163(f), an "issuer sanction," denies an interest deduction on "registration-required obligations" not issued in registered form. For a discussion of other sanctions imposed by TEFRA, see *supra* note 89.

Congress realized, however, that it would be impractical to require registration of all obligations. Therefore, Congress excluded certain obligations, namely, those issued by individuals, those of a type not offered to the public, and those with maturities of less than one year, from regulation requirements. Congress also excluded obligations sold to foreign persons, so long as the obligations met requirements to ensure sale only to non-U.S. persons. I.R.C. § 163(f) embodies these restrictions and excludes from its provisions those categories of obligations which Congress believed should not be "registration-required."

¹¹⁰ This interpretation is ironic in view of the fact that Congress' expressed purpose in enacting the repeal legislation was to assist smaller companies which did not have the resources to use international finance subsidiaries. See *supra* note 33; see also EXPLANATION OF THE 1984 ACT, *supra* note 6, at 392 (finance subsidiaries provided "incomplete access to the Eurobond market"). These companies might readily use the private placement method in order to save money and to better place their obligations in a market where many investors might otherwise prefer to invest in obligations of a larger issuer rather than those of a smaller, less-known company. Letter from Oppenheimer, Wolff, Foster, Shepard & Donnelly to the Commissioner of the Internal Revenue Service 10 (May 24, 1985) (available through Tax Notes Microfiche Service, Doc. 85-4901) [hereinafter cited as Oppenheimer Letter].

¹¹¹ The aggregate concept of partnership taxation is well reflected in I.R.C. § 701, which provides "a partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." Moreover, partners are generally held individually liable for partnership debts and those debts may be satisfied even out of personal assets. Finally, if the temporary regulations are correct in excluding debts of natural persons from the definition of "portfolio interest," they should address whether interest paid on obligations issued by partnerships and other noncorporate groups qualifies for repeal legislation. Letter from ABA Tax Section members to Treasury, 25 TAX NOTES 1199 (Dec. 24, 1984).

cilities (RUFs).¹¹² The exclusion of such obligations seems particularly unfair since, under a separate Code section, obligations with maturities of less than six months are exempt from withholding.¹¹³ Thus, only obligations with maturities of six months to one year are subject to withholding.

Several arguments can be advanced against Treasury's interpretation that "portfolio interest" be limited to interest on "registration-required obligations." The most potent attack on the regulations' validity lies in the statutory language itself: the relevant Code section refers only to the requirements of I.R.C. § 163(f)(2)(B) (the foreign-targeted exception) in defining portfolio interest; it does not refer to I.R.C. § 163(f)(2)(A).¹¹⁴ Moreover, the section refers to I.R.C. § 163(f)(2)(B) only in defining "portfolio interest" on bearer obligations, yet the Service has extended its restriction to both bearer and registered obligations.

There are other arguments against the Service's position on "registration-required" obligations. The distinction created by the Service ignores the rationale behind Congress' original enactment of I.R.C. § 163(f)(2)—that of ensuring that interest deductions would be allowed only where the interest income would be reported or collected at source, or where the risk of not reporting such income was small.¹¹⁵ The Ser-

¹¹² A revolving underwriting facility (RUF) is a funding mechanism used by companies which consists of the issuance of short-term Euronotes or Euro-Commercial Paper, backed in part by a syndicated revolving credit. Dungan, *The Structure of Revolving Underwriting Facilities*, in *EURO-NOTES-RUFs, TRUFs, NIFs, SNIFs AND BONUSES* 9 (1985). The notes issued under these facilities must currently be structured with a maturity of no more than 183 days from issuance, so that withholding is not imposed thereon. I.R.C. §§ 871(a)(1)(A) and (C), 871(g)(1)(B), 881(a)(1) and (3). Were the maturity to extend beyond that date, withholding would be required on the original issue discount under Temp. Treas. Reg. § 35a.9999-5(a), Q&A-6. RUFs are becoming increasingly popular as credit facilities. In the first six months of 1985, \$18.7 billion in credit was arranged in this form. *Financial Times*, Jul. 8, 1985, at 17, col. 2. In May 1985, Sears Roebuck and Co. and Sears Roebuck Acceptance Corp. signed an agreement arranging for a \$500 million RUF. Gurnee, *Sears Roebuck and Co: A Corporate Issuer*, in *EURO-NOTES-RUFs, TRUFs, NIFs, SNIFs AND BONUSES* 93 (1985).

¹¹³ I.R.C. §§ 871(a)(1)(A) and (C), 871(g), 881(a)(1) and (3).

¹¹⁴ I.R.C. §§ 871(h)(2) and 881(c)(2). Commentators have criticized the Treasury's interpretation of the statute on this basis. Letters of Willard B. Taylor of Sullivan & Cromwell in New York and Dickson G. Brown of Simpson, Thatcher & Bartlett in New York to the Treasury, 25 *TAX NOTES* 611 (Nov. 12, 1984); Letter from ABA Tax Section members to Treasury, 25 *TAX NOTES* 1199 (Dec. 24, 1984); Oppenheimer Letter, *supra* note 110, at 5. Had Congress intended that eligible obligations be registration-required, it would have made the requirement explicit. *Id.* at 7.

¹¹⁵ In enacting I.R.C. § 163(f), Congress distinguished between registration-required and non-registration required obligations in order "to add additional safeguards to those obligations whose sheer numbers present a greater potential for tax avoidance." Oppenheimer Letter, *supra* note 110, at 4. Congress exempted obligations which were short-term, not publicly-offered, or issued by a natural person from the denial of interest deduction not only because it believed registration of such obligations would be onerous, but also because such obligations are relatively few in number. *Id.* at

vice's interpretation is also inconsistent with the legislative intent behind the repeal legislation. The enacted legislation was chosen by Congress over other proposals which would have limited the repeal to Eurobond-type offerings (which are publicly offered).¹¹⁶ Congress, however, adopted a broader form of repeal, extending to interest paid on "any" obligation meeting certain requirements.¹¹⁷ This latter position is supported by Representative Sam Gibbons, a co-author of the repeal legislation, who insists that the repeal legislation was intended to apply to privately-placed obligations.¹¹⁸

The Service's restrictive interpretation also appears unwarranted in light of the safeguards that Congress built into the legislation to ensure that interest income received by United States payees would be reported.¹¹⁹ Bearer obligations are subject to controls on distribution and payment of interest. Registered obligations disclose the payee's identity. In either case, foreign payee status is virtually assured. Thus the registration-required standard "does not further a Congressional policy of minimizing the risk of tax avoidance but merely capriciously denies the repeal of the withholding tax on interest to certain types of obligations."¹²⁰

Finally, the Service's restrictive interpretation discriminates in favor of larger corporations by denying the benefits of private placements to smaller corporations that often cannot afford the expense of a public offering type of registration.¹²¹

3. Thus, the distinction between registration-required obligations was not made in order to deny an interest deduction on obligations exempt from registration requirements.

¹¹⁶ H.R. 4029 (introduced by Rep. Barnard) contained this limitation. *See supra* text accompanying note 49.

¹¹⁷ I.R.C. § 871(h)(2)(A).

¹¹⁸ At a hearing on H.R. 1800, a Technical Corrections Bill, held on May 16, 1985 before the House Ways and Means Committee, Treasury argued that the repeal should be interpreted as applying only to public offerings. Rep. Gibbons retorted, "[T]hat's not the way the law is written." When Treasury admitted that including both types of obligations was "a fair interpretation," Gibbons snapped "[I]t's not only fair, that was my intent, and I'm the author." WEEKLY TAX REP. (BNA), May 20, 1985, at 641. Sen. John Chafee, who co-authored the Senate companion bill to Gibbons' H.R. 3025, however, supports Treasury's position. At a June 5, 1985 Senate Finance Committee hearing on S. 814, a Technical Corrections Bill, Chafee observed, "It seemed clear to me on 30-percent withholding we were dealing only with public issues." 109, DAILY REP. FOR EXECUTIVES (BNA) G-3 (Jun. 6, 1985).

¹¹⁹ In order to obtain the exemption for "portfolio interest," bearer debt must meet the three restrictions contained in I.R.C. § 163(f)(2)(B), while registered debt must be accompanied by a statement indicating that the owner is not a U.S. person. I.R.C. §§ 871(h)(2) and 881(c)(2). Any obligations issued in the non-registration required category would still have to meet these criteria to qualify for exemption from withholding.

¹²⁰ Oppenheimer Letter, *supra* note 110, at 10.

¹²¹ *See supra* note 110 and accompanying text. It will be even more difficult for such companies to obtain foreign financing in light of the Service's recent revenue rulings which invalidate the use of

The restriction of repeal benefits to registration-required obligations is an issue that is likely to be resolved soon. The Treasury Department has proposed, as an addition to the Technical Corrections Bill of 1985, a provision that would restrict "portfolio interest" to interest paid on obligations issued pursuant to a public offering.¹²² It is difficult to predict whether Congress will reject or uphold Treasury's interpretation of the repeal legislation. Although Treasury did concede its position on mortgage pass-through securities,¹²³ it is unlikely to do so with respect to the general requirement that an obligation be registration-required to qualify for the repeal legislation. Moreover, since the issuer most likely to be

finance subsidiaries on the conduit theory, Rev. Rul. 84-152, 1984-2 C.B. 381 and Rev. Rul. 84-153, 1984-2 C.B. 383. These rulings have been criticized on various grounds, however; see *infra* notes 125-47 and accompanying text. Moreover, Congress has expressed its intent to prohibit certain back-to-back loans which could have been used by smaller companies in order to obtain financing. CONFERENCE REPORT, *supra* note 60, at 937-38. See Oppenheimer Letter, *supra* note 110, at 10-14.

¹²² See Presentation of Roger Mentz, Deputy Assistant Secretary for Tax Policy, at the Senate Finance Committee hearing held June 5, 1985 (available through Tax Notes Microfiche Service, Doc. 85-4808 at 16-17). Contending that such a proposal is "good tax policy," Mentz offered two reasons for Treasury's view. First, he argued, the policy basis for unilateral repeal does not apply to excluded obligations, *i.e.*, "trade indebtedness and obligations issued in private placements." Since publicly-offered issues trade in active secondary markets, he noted, unilateral repeal was warranted because there was no way that an issuer could ensure that an obligation would be held only by residents of a treaty country. Privately-placed obligations or trade debt can be targeted to residents of a treaty country, however, thereby incurring a lower or zero withholding tax rate. The second reason offered by Mentz for Treasury's limitation on the repeal legislation was that other countries generally have not repealed their withholding taxes on such obligations. Thus, argued Mentz, any exemption should be negotiated through tax treaties, so that reciprocal treatment can be obtained for U.S. taxpayers. In other words, Treasury wants to use the tax as a "bargaining chip" in its treaty negotiations.

Treasury's two-part rationale for limiting the repeal legislation appears flawed, however, upon closer examination. First, while non-publicly offered issues might be initially placed with residents of a treaty country, resales of such obligations would be extremely difficult, perhaps to the point of discouraging an investor from his initial purchase. The obligation would have to be resold to another resident of a treaty country. Moreover, to ensure that the purchaser was such a person, the obligations would have to be registered in some way. Foreign investors are reluctant, however, to purchase obligations which are not in bearer form. Thus, the number of willing and able purchasers would be few, causing a probable discount in the resale price. Private placement through treaty exemption is not, therefore, as appealing as Treasury would make it sound. These drawbacks, therefore, place further restrictions on the smaller company attempting to raise capital abroad.

Treasury's second rationale for limiting the repeal legislation—for use as a "bargaining chip"—is equally flawed. First, there are other types of interest which are still subject to treaty negotiation (*e.g.*, interest on ordinary bank loans and related party debt). Moreover, Treasury's ability to negotiate zero rates of withholding have been successful in only about a third of the cases. Finally, since repeal of U.S. withholding taxes serves to attract more investment into this country, it is questionable whether such an offer would be much of a bargaining chip with countries that wish to keep their residents' capital within their own borders. Letter from Joseph Guttentag, of Arnold & Porter, to Deputy Assistant Treasury Secretary Roger Mentz (Jun. 12, 1985) in 27 TAX NOTES 1463 (Jun. 24, 1985).

¹²³ See *supra* note 104 and accompanying text.

interested in eliminating that requirement is the smaller corporation,¹²⁴ it is questionable whether a strong constituency can be rallied to persuade Congress to reject the Service's interpretation.

*E. Treasury Opens the Window on Eurobond Issues
and Freezes the Antilles*

On October 15, 1984, the Service issued two revenue rulings which seriously impacted the status of financing transactions effected through Netherlands Antilles companies. Rev. Rul. 84-152 (and related G.C.M. 37940) involved a back-to-back loan within a related group of corporations,¹²⁵ while Rev. Rul. 84-153 involved a Eurobond offering made by a Netherlands Antilles subsidiary of a United States parent.¹²⁶ In both cases, however, the Service found that the Antillean subsidiary was a

¹²⁴ See *supra* notes 110 and 121 and accompanying text.

¹²⁵ Rev. Rul. 84-152, 1984-2 C.B. 381. In Rev. Rul. 84-152, a Swiss parent company (P) had a wholly-owned U.S. subsidiary (R) and a wholly-owned Antillean subsidiary (S). In order to meet R's need for working capital, on August 1, 1984 P lent the required funds to S at 10% and S reloaned the proceeds of this loan to R at 11%. While "neither R nor S was thinly capitalized," S was not sufficiently liquid to make the loan to R in the absence of funds supplied by P. The net interest income was retained by S, and the Ruling provides that the transactions "may (have) serve(d) some business or economic purpose." The companies attempted to claim the benefit of the U.S.-N.A. treaty for interest paid by R to S.

The Ruling, under the rationale discussed *infra* note 130, concludes that S is a mere "conduit" and that the primary (but not sole) purpose of involving S was to obtain the benefits of the U.S.-N.A. treaty and avoid the payment of U.S. taxes. Accordingly, the Service restructured the transaction as if the obligation had been issued by P. Rev. Rul. 84-152, 1984 C.B. at 382.

G.C.M. 37940 (Apr. 24, 1979, declassified Jan. 30, 1985) contains a proposed ruling which is similar to Rev. Rul. 84-152, but which also contains several significant differences. In the G.C.M., the Swiss parent (P) could not supply its own capital, but could guarantee a loan since it had an excellent credit rating and considerable unencumbered assets for security. P negotiated a loan arrangement with a Swiss bank (without participation by S or R) to lend funds to S at 10% and P guaranteed repayment of the loan in the event of default. S reloaned the funds to R at 11%.

While reaching the same conclusion as Rev. Rul. 84-152 (*i.e.*, that S is a mere "conduit" and that the U.S.-N.A. treaty is inapplicable), the G.C.M. does appear to have more faithfully applied the precedents cited therein. Since the G.C.M. states that the *sole* reason for the transaction was the avoidance of U.S. taxes and since the arrangement involved a guarantee by P, the G.C.M.'s citations to *Aiken Indus. v. Commissioner*, 56 T.C. 925 (1971) and to *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972), 72-2 USTC ¶ 9494 seem to better support the "conduit" theory than does Rev. Rul. 84-152. See *infra* note 127.

¹²⁶ Rev. Rul. 84-153, 1984-2 C.B. 383. In Rev. Rul. 84-153, a U.S.-owned Antillean subsidiary (S) lent the proceeds of two public Eurobond offerings to its U.S. affiliate (R) at 1% over the interest rate on the Eurobonds. These offerings were made on July 1 and September 1, 1984. Neither S nor R was thinly capitalized, S retained the net revenues, and the loan was said to serve "some business or economic purpose." While the Ruling does not state that the U.S. parent guaranteed the repayment of the bonds, such an arrangement is typical in most Netherlands Antilles Eurobond financings.

Utilizing the same conduit/primary purpose rationale as that used in Rev. Rul. 84-152, the Ruling concludes that the U.S.-N.A. treaty exemption is not available. Moreover, notes the Ruling, the I.R.C. §§ 871(h) and 881(c) exemptions for "portfolio interest" do not apply. See *infra* note 130.

mere "conduit"¹²⁷ and that the use of the subsidiary lacked "sufficient business purpose" to overcome the conduit nature of the transaction. Accordingly, the Service denied the U.S.-N.A. treaty exemption for United States source interest paid to the subsidiary and imposed withholding tax on such payment.¹²⁸ The rulings were apparently issued to enunciate new tests to be applied in the determination of whether certain financing corporations or transactions would be disregarded for tax purposes. The rulings, however, "provide little guidance as to the application, scope or meaning of these tests."¹²⁹ Moreover, the rulings appear to be inconsistent with prior case law and with authority cited in the rulings themselves.¹³⁰ The Service has made no attempt to reconcile these au-

¹²⁷ The finding that S was a conduit was based on the fact that S did not obtain "complete dominion and control" over the interest payments it received. Such dominion and control is required, according to the rulings, in order for the interest to be "derived by" S pursuant to the U.S.-N.A. treaty. That treaty provides that:

(i)Interest . . . derived from sources within the United States by a resident or corporation of the Netherlands not engaged in trade or business in the United States through a permanent establishment shall be exempt from United States tax. . . (emphasis supplied).

Art. VIII, U.S.-N.A. Treaty, *supra* note 23. In support of the requirement for complete dominion and control, both rulings cite *Aiken Indus. v. Commissioner*, 56 T.C. 925 (1971), *acq.* 1972-2 C.B. 1.

Furthermore, note the rulings, while the transaction (and S's involvement therein) "may serve some business or economic purpose," the use of S "lacks sufficient business or economic purpose to overcome the conduit nature of the transaction." Rev. Rul. 84-152 at 382; Rev. Rul. 84-153 at 384 (emphasis supplied). Thus, the interest payments were not considered to be "derived by" S and the U.S.-N.A. treaty exemption was unavailable. *Id.* For a criticism of the rationales applied in the rulings, see *infra* note 130.

¹²⁸ Rev. Rul. 84-152 at 382; Rev. Rul. 84-153 at 384.

¹²⁹ LeDuc & Robinson, *The New Assault on Related Party Financing: How Far Will the Service Go?*, 11 INT'L TAX J. 167, 168 (1985).

¹³⁰ Both rulings and the G.C.M. cite *Aiken Industries*, 56 T.C. 925 in holding that the interest was not "derived by" the Antillean subsidiary because the subsidiary did not obtain complete dominion and control over the payment. However, *Aiken* is distinguishable from the rulings and the G.C.M. in that, in *Aiken*, the Bahamian corporation disregarded by the Service was committed to pay out exactly what it got, making no profit on the transaction. In the rulings and G.C.M. however, the Antillean subsidiary made a profit on the transaction from the interest rate differential.

The rulings also cite *Gregory v. Helvering*, 293 U.S. 465 (1935) (sham doctrine) and *Aiken* as authority for the holding that the use of the Antillean subsidiary lacked sufficient business or economic purpose to overcome the conduit nature of the transaction. However, in both *Aiken* and *Gregory*, the courts found that the transactions had no business or economic purpose. The rulings, by contrast, indicate that there was some business purpose involved. As one commentator notes, "[T]he emphasis upon the strength or importance—as opposed to the mere existence—of a business purpose may represent one of the most important departures of the two rulings from prior law." LeDuc & Robinson, *supra* note 129, at 185. See *Sam Siegel*, 45 T.C. 566 (1966), *acq.* 1966-2 C.B. 7 and *Perry R. Bass*, 50 T.C. 595 (1968), wherein the court refused to disregard the existence of corporations formed in Panama and Switzerland, respectively, even though the incorporations were found to be for tax avoidance purposes.

Finally, the G.C.M. cites *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972), 72-2 USTC ¶ 9494 as support for reattributing the loan to the parent as a result of the parent's guarantee of the loan. However, in *Plantation Patterns*, the loan was reattributed to a shareholder-

thorities or to clarify its tests. Consequently, the rulings have also created a great deal of uncertainty in the area.¹³¹ Finally, in unilaterally overruling the U.S.-N.A. treaty, the rulings are bad policy and a potential violation of international law.¹³²

guarantor because the nominal debtor corporation had a debt-to-equity ratio of 214:1. In the G.C.M., however, the Antillean subsidiary is said not to be thinly capitalized.

Several commentators have criticized the rulings, both for their incorrect application of precedent and for their effect on treaty obligations and international relations. On the latter issue, see *infra* note 132. Criticisms include Cole & Musher, *Rev. Ruls. 84-152, 84-153 and G.C.M. 37940 Depart from U.S. Treaty Obligations*, 14 TAX MGMT. INT'L J. (BNA) 265 (1985); Feingold & Fishman, *supra* note 5, at 172; Fogarasi & Renfroe, *Is the Benefit of the U.S.-Netherlands Antilles Treaty Terminated for Financing Companies?*, 13 TAX MGMT. INT'L J. (BNA) 442 (1984); Fuller, *G.C.M. 37940: Rev. Rul. 84-152 and the Conduit Use of Treaties*, 64 TAXES INT'L 76 (Feb. 1985); LeDuc & Robinson, *supra* note 129; Segal & Davis, *supra* note 5, at 133-34. See also Letter from United States Council for International Business to the Treasury (Jan. 18, 1985) (available through Tax Notes Microfiche Service, Doc. 85-850); Letters from Congress objecting to the rulings, *infra* note 140.

¹³¹ It is unclear, for example, whether the "dominion and control" test and the "sufficient business or economic purpose" test, if valid, should be applied alternatively or in conjunction. LeDuc & Robinson, *supra* note 129, at 185-86, 191. Additional uncertainties are raised by Fogarasi & Renfroe, *supra* note 131, at 445-46.

While the retroactive application of the rulings was initially an area of uncertainty, the issuance under I.R.C. § 7805(b) of seven private letter rulings and Rev. Rul. 85-163 has substantially allayed those concerns. See *infra* notes 143-45 and accompanying text.

¹³² In their attempt to combat treaty shopping, the rulings also fail to address the 1963 Protocol to the U.S.-N.A. treaty. That Protocol was specifically concerned with third country access to the Treaty. S. REP. NO. 10, 88th Cong., 2d Sess. (1964), reprinted in 1965-1 C.B. 633, 665. The response of the Protocol to this issue was that Antillean companies would be entitled to treaty benefits if such companies were subject to full Antillean tax rates (and not entitled to special tax benefits, including a 3% tax rate). *Id.* at 669. Contemporaneously with the ratification of the Protocol, the Service issued Rev. Rul. 65-16, 1965-1 C.B. 626, which held that Antillean companies electing to be taxed under Art. 8A of the Antilles Profit Tax Ordinance (at approximately 30% on net profits) would not be considered to be entitled to special tax benefits. Most Antillean finance subsidiaries have made this election and thus, should be entitled to the Treaty exemption on U.S. withholding tax.

Moreover, the Protocol addressed the so-called "secondary tax" exemption in Article XII. That exemption allowed Antillean companies to pay interest to third country residents free of U.S. withholding tax. In rejecting any limitation on this exemption, the Treasury stated:

In recommending ratification of Article I of the Protocol, the Treasury continues to recognize the desirability of encouraging foreign portfolio investment in the United States during our present imbalance of international payments. To this end, care has been taken not to remove from the treaty those provisions (such as the exemption of Netherlands Antilles corporations from the so-called 'secondary tax' on dividends and interest paid by them to persons other than U.S. persons) which have long been an intended benefit of the U.S. treaty program. *Id.* at 669. Since the 1963 Protocol established specific conditions for the exemption from U.S. withholding tax on U.S. source interest, and rejected a limitation on the exemption from "secondary tax," it appears that the Treasury was attempting to unilaterally rewrite the Protocol in its issuance of the rulings. Cole & Musher, *supra* note 130, at 271.

From a policy standpoint, the rulings are also subject to criticism. The issuance of the rulings departs from a long-standing tradition of renegotiation with competent authority of the treaty country to solve problems of treaty shopping. Fogarasi & Renfroe, *supra* note 130, at 446. Moreover, the rulings could lead to discriminatory treatment of the Antilles and other treaty partners whose treaty contains the same "derived by" language (as opposed to simply "paid to"). *Id.* Finally, since the

While Rev. Rul. 84-152 is potentially broader than Rev. Rul. 84-153,¹³³ the latter ruling had a greater impact on traditional Eurobond offerings done through Antillean subsidiaries. Significantly, in Rev. Rul. 84-153, the Service found that interest, paid on obligations issued on July 1, 1984 through an Antillean subsidiary, was subject to the thirty percent withholding tax.¹³⁴ First, the Ruling held that the treaty exemption was unavailable because interest had not been "derived . . . by" the subsidiary, as the treaty language requires. Instead, the Service considered the Antillean subsidiary to be a mere "conduit" for the passage of interest payments to foreign bondholders.¹³⁵ Second, the ruling held that the exemption of withholding on "portfolio interest" was not available because the bonds were issued on July 1, 1984, prior to the effective date of the repeal legislation (July 18, 1984), but subsequent to the date provided in the 1984 Act for the grandfathering of such Antillean financing arrangements (June 22, 1984).¹³⁶

In denying the benefits of the repeal legislation to the interest payment made on the July 1, 1984 obligation, the Service had, in effect, given notice to companies who had floated Eurobond issues during the "window period" (June 22-July 18, 1984) that such issuances would not qualify for the legislation.¹³⁷ These companies were thus faced with the

rulings can be said to unilaterally override the U.S.-N.A. Treaty (and possibly others), there is a possible violation of international law involved. *Id.* at 444.

¹³³ Although Rev. Rul. 84-153 had more immediate impact on companies who had issued Eurobonds through an Antillean finance subsidiary, Rev. Rul. 84-152 appears to have had a broader impact on treaty shopping arrangements through treaties similar to the U.S.-N.A. Treaty. Moreover, Rev. Rul. 84-152 "could be interpreted as being retroactive forever." 201 DAILY REP. FOR EXECUTIVES (BNA) G-4 (Oct. 17, 1984) (statement of John Venuti). "The implications for other treaties and other types of income is the key question." *Id.* (statement of H. David Rosenbloom, former Treasury Department International Tax Counsel).

¹³⁴ See *supra* note 126 for a summary of the facts and conclusions of Rev. Rul. 84-153.

¹³⁵ *Id.* See *supra* note 130.

¹³⁶ Section 127(g) of the 1984 Act provided that the repeal legislation applied only to obligations issued after the effective date.

See *supra* note 76 for a discussion of the grandfathering rule contained in the 1984 Act.

In Rev. Rul. 84-153, there was also a September 1, 1984 issuance of bearer debt. Those obligations were found to be ineligible for the grandfathering provision since they were issued after June 22, 1984. Moreover, the obligations were also found to be ineligible for the repeal legislation, because they "did not meet the requirements of Section 163(f)(2)(B) of the Code and the regulations thereunder." Rev. Rul. 84-153 at 383.

¹³⁷ There were at least nine corporations that had issued Eurobonds through Antillean finance subsidiaries between June 22 and July 18, 1984, including First Federal of Michigan—\$200 million; G.M.A.C.—\$200 million; G.E.C.C.—\$600 million; and Sears Roebuck & Co.—\$500 million. 202 DAILY REP. FOR EXECUTIVES (BNA) G-7, -8 (Oct. 18, 1984).

While not explicitly stated, Rev. Rul. 84-153 actually resulted in the creation of two window periods. (1) obligations issued between June 22 and July 18, 1984. Although these obligations would not qualify for the "portfolio interest" exemption nor for treaty benefits (under the facts of the Ruling), relief requests under I.R.C. § 7805(b) were available. See *infra* note 142. (2) Obligations

prospect of redeeming and refinancing debt of almost \$2 billion¹³⁸ or paying the withholding tax and increasing their debt costs by forty-three percent,¹³⁹ both of which were unattractive alternatives.

The Service's response to the ensuing market outrage¹⁴⁰ was as poorly calculated as its initial issuance of the Rulings had been. While unofficial responses seemed to downplay the gravity of the Rulings,¹⁴¹ the official response of the Service was that corporations affected by the Rulings should apply for relief through a ruling request.¹⁴² Such requests, filed under I.R.C. § 7805(b), would be based on the fact that the issue was in process prior to June 22, 1984, and would receive expedited

issued between July 18 and August 22, 1984 (the date of the issuance of the temporary regulations under the repeal legislation). These obligations will not be affected if they meet the requirements of I.R.C. § 163(f)(2)(B) as subsequently interpreted by the regulations. However, if they do not meet those requirements, withholding will apply. Fogarasi & Renfro, *supra* note 130, at 444. While relief under I.R.C. § 7805 was not originally available for issuances during the second period, Rev. Rul. 85-163 will prevent the retroactive application of the Ruling to such issuances. *See infra* notes 145-46.

¹³⁸ Although interest rates had generally fallen from June-July 1984 until October 1984 (when the rulings were issued), refinancing would have been undesirable because of the stigma it would attach to an issuer's reputation in the market.

¹³⁹ *See supra* note 19.

¹⁴⁰ In addition to the criticisms raised by affected companies and commentators, certain members of Congress wrote to the Treasury expressing their objections to the application of the rulings to Antillean Eurobond issues. Letters of Reps. Ronnie Flipppo, Frank Guarini, Richard Schulze and William Thomas to the Treasury, 27 TAX NOTES 1332 (Jun. 17, 1985) and 27 TAX NOTES 1438 (Jun. 24, 1985). In response to these letters, Ronald Pearlman, Assistant Secretary for Tax Policy, took the approach that the result of the rulings was mandated by Congress' action in grandfathering obligations issued before June 22, 1984. Prior to the repeal legislation, Pearlman noted, the finance subsidiaries had been subject to various attacks on audit. In enacting the repeal legislation and grandfathering certain issues, Congress removed all policy reasons for the use of such finance subsidiaries. "Indeed," said Pearlman, "the legislative history of the 1984 Act indicates that we are required not to respect such companies." Letter of Ronald Pearlman to Congressmen, *reprinted in* 28 TAX NOTES 1105 (Sept. 2, 1985).

Pearlman's analysis is questionable. First, the Conference Committee Report on the 1984 Act clearly provides, "[N]o inference should be drawn from (the grandfathering rule) regarding the proper resolution of other tax issues." CONFERENCE REPORT, *supra* note 60, at 938. Second, there are clearly some remaining instances where finance subsidiaries may have to be resorted to in order to issue Eurobonds free of the 30% withholding tax. Most notably, private placements are not eligible for the repeal legislation, *see supra* note 110. Also, certain CFCs, banks and 10%-or-more owners are similarly ineligible for the exemption, *see supra* notes 66-69. *See also* LeDuc & Robinson, *supra* note 129, at 191-96 for other cases in which the finance subsidiary structure might still be used.

¹⁴¹ Unnamed Treasury officials are reported to have said, the window "is only an incidental consequence of this ruling. The real issue is, if you go through an Antillean finance subsidiary, a certain level of capitalization will be required for the subsidiary to be considered financially independent." 203 DAILY REP. FOR EXECUTIVES (BNA) G-3 (Oct. 19, 1984). This statement, however, belies the basis for the rulings because in each case, the facts stated that the Antillean subsidiary was not thinly capitalized. *See supra* notes 125-26.

¹⁴² I.R.S. News Release 110 (Oct. 18, 1984), *reprinted at* 84-10 CCH ¶ 6879.

treatment.¹⁴³ On February 19 and 20, 1985, favorable rulings were given to seven issuers.¹⁴⁴ The same ruling was, in effect, given to all taxpayers through the Service's recent issuance of Rev. Rul. 85-163.¹⁴⁵ That ruling, however, is hardly a "safe harbor," since it merely provides that the holdings of Rev. Ruls. 84-152 and 84-153 will not be applied retroactively to obligations issued on or before October 15, 1984, or in process on or before that date.¹⁴⁶ Clearly, it is the Service's intention to continue to attack obligations which fall into the window period. If based on the "conduit" rationale espoused in Rev. Ruls. 84-152 and 84-153, those attacks may also affect any taxpayer utilizing a treaty similar to the U.S.-N.A. treaty for financing transactions.¹⁴⁷

IV. POLICY ARGUMENTS

Since its introduction, the repeal legislation has engendered debate in political and financial circles as to the likely effects of the legislation on the United States capital market and on the economy as a whole.¹⁴⁸ An analysis of these arguments, however, supports the conclusion that the long-term effects of the repeal legislation will be positive.

A. Capital Formation

While critics of the repeal legislation contend that the measure will result in little capital formation,¹⁴⁹ it is more widely believed that the repeal of the withholding tax will be successful in attracting new capital to this country, thereby enabling businesses to become more efficient, to lower the cost of their goods, and to compete with imported products.¹⁵⁰ Moreover, as the supply of new capital (estimated in one study to be \$5-7 billion)¹⁵¹ increases, United States interest rates should decrease¹⁵² and

¹⁴³ *Id.*

¹⁴⁴ L.T.R.s 8520055, 8520061, 8520062, 8520092 (supplemented by 8528031), 8520093, 8520094 and 8520095 (Feb. 19-20, 1985). The letter rulings each conclude: "Pursuant to the authority contained in section 7805(b), the holding of Rev. Rul. 84-153 will not be retroactively applied to the obligations issued on (date) by (company)."

¹⁴⁵ Rev. Rul. 85-163, 1985-41 I.R.B. 25.

¹⁴⁶ *Id.* October 15, 1984 represents the date that the revenue rulings were issued.

¹⁴⁷ See *supra* note 132.

¹⁴⁸ For a summary of the policy arguments made by proponents and opponents of the repeal legislation see JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 20-29.

¹⁴⁹ See *infra* note 155 and accompanying text.

¹⁵⁰ See, e.g., *Minor Tax Bills*, *supra* note 14, at 91, 94 (report of the Securities Industry Association).

¹⁵¹ *Id.*

¹⁵² *May 1, 1984 Hearings*, *supra* note 3, at 47 (statement of Thomas Healey of the Treasury Dept.).

come into equilibrium with Eurobond market interest rates.¹⁵³ Thus, these two markets should become more integrated and efficient,¹⁵⁴ broadening and facilitating trading in the secondary securities market and making the obligations more marketable.

The benefit of the repeal legislation should not be diluted, as opponents¹⁵⁵ had argued, by the fact that many exceptions to withholding already existed prior to the passage of the legislation.¹⁵⁶ These exceptions, such as the use of treaties, statutory exemptions, and the foreign tax credit, were not nearly as comprehensive as the repeal legislation. There were, for example, tax-exempt foreign investors who could not utilize the foreign tax credit and investors from countries with which the United States had no treaty.¹⁵⁷ These investors will now be able to invest in United States obligations without the imposition of a withholding tax at source. This analysis also refutes the argument of opponents that the benefits of repeal would accrue only to "tax evaders" since, prior to the repeal, all other investors were exempt by treaty or through the use of credits.¹⁵⁸

B. Employment and Balance of Trade

The repeal legislation should help to increase employment in the United States as companies transform new capital funds into the production of goods.¹⁵⁹ Moreover, the legislation may be successful in bringing

¹⁵³ *Id.* at 37, 41.

¹⁵⁴ *Id.* at 33-34 (statement of Ronald Pearlman of the Treasury Dept.).

¹⁵⁵ Along with several Congressmen, notably Reps. Stark, Dorgan and Metzenbaum, the most outspoken opponents to the repeal legislation were the AFL-CIO and a consumer group, Citizens for Tax Justice. In their statement, included as an exhibit to the May 1, 1984 hearings, the AFL-CIO cited the problems they associated with the repeal legislation: speculative money, which creates instability and uncertainty, tax preferences for foreigners, and the image of the United States as a tax haven country. *May 1, 1984 Hearings, supra* note 3, at 312-13. The Citizens for Tax Justice also testified at the hearings in opposition to the repeal legislation. Robert S. McIntyre, the group's Director, addressed the following concerns: the rise in the strength of the dollar, worsening trade deficits, the increasing cost of U.S. exports and the resultant loss of jobs in those sectors, and the transformation of the United States into a tax haven country. *Id.* at 238-39 (statement of Robert S. McIntyre).

Of course, the Netherlands Antilles also opposed the repeal legislation. *See infra* note 198 and accompanying text.

¹⁵⁶ *See supra* note 20 for a list of these exceptions; *see also May 1, 1984 Hearings, supra* note 3, at 242 (statement of Robert S. McIntyre); *1976 Hearings on Foreign Investment, supra* note 39, at 35 (statement of Hugh Ault, Professor at Boston College).

¹⁵⁷ *See supra* note 21.

¹⁵⁸ *See supra* note 156.

¹⁵⁹ "The price of less capital formation is higher unemployment." *1976 Hearings on Foreign Investment, supra* note 39, at 21 (statement of Robert Roosa, Chairman of NYSE Advisory Committee).

back to the United States some of the financing activity which shifted to London in the 1970s and 1980s, and, in so doing, should recapture the related employment and tax receipts from this sector of the economy.¹⁶⁰ Using a capital/employment ratio of \$24,000/1, one estimate suggests that the repeal legislation could produce as many as 250,000 new jobs.¹⁶¹

It is also likely, however, that the increase in foreign investment in United States assets will strengthen the dollar somewhat, resulting in an increase in the United States trade balance deficit and higher unemployment in export-related industries.¹⁶² The repeal legislation is not, however, solely responsible for this result; the strength of the dollar is also directly attributable to federal deficit levels,¹⁶³ to the weakness of other countries' economies, and to the attractiveness of United States assets as a whole. Moreover, to the extent that the repeal legislation results in a decrease in domestic interest rates, this may also help to reduce the exchange rate.¹⁶⁴ Finally, the increase in the strength of the dollar should not be large, because most of the new capital will come from a shift from other dollar-denominated investments to dollar-denominated Eurobonds.¹⁶⁵

C. Efficiency of Financing

The use of foreign finance subsidiaries as an indirect means of accessing the Eurobond market was an inefficient system which increased the cost of raising capital.¹⁶⁶ Moreover, small business could rarely afford the legal and financial expertise necessary to take advantage of the Antilean finance subsidiary system.¹⁶⁷ The repeal legislation will simplify the method by which companies access the Eurobond market and may allow small businesses to compete in that market. Securities experts are uncertain as to whether or not foreign investors will be receptive to issues of small, unknown companies.¹⁶⁸ Even if these companies are not success-

¹⁶⁰ *Hearings on S. 1557, supra* note 30, at 244 (statement of John Evans of Morgan Stanley & Co.).

¹⁶¹ *Minor Tax Bills, supra* note 14, at 137 (statement of John Hennessy of First Boston Corp.).

¹⁶² *May 1, 1984 Hearings, supra* note 3, at 238 (statement of Robert S. McIntyre).

¹⁶³ *Id.*

¹⁶⁴ *Id.* at 51 (statement of Rep. Barber Conable).

¹⁶⁵ "Any shift into dollar investments is likely to be small in relation to the annual foreign demand for dollars . . . which now totals more than \$400 billion." *Id.* at 33 (statement of Ronald Pearlman of the Treasury Dept.).

¹⁶⁶ *Minor Tax Bills, supra* note 14, at 132 (statement of John Hennessy of First Boston Corp.).

¹⁶⁷ *Hearings on S. 1557, supra* note 30, at 244 (statement of Nicholas Rey of Merrill Lynch).

¹⁶⁸ Compare the remarks of John Evans of Morgan Stanley (sophisticated foreign investors would participate in higher yield domestic issues of smaller and lesser-known companies) *May 1, 1984 hearings, supra* note 3, at 254, with those of Robert Loverd of First Boston (overseas investors are extremely conservative and will not be interested in issues of small, lower credit corporations), *id.* at

ful in issuing bonds in the foreign market, however, they should receive some benefit from the expected reduction in United States interest rates.¹⁶⁹ Unfortunately, the real benefits to small companies may be forestalled or eliminated by the Treasury's interpretation that private placements will not qualify for the repeal legislation.¹⁷⁰

D. Control of Money Supply and Reliance on Foreign Debt

Eurobond money is a long-term (five-to-ten year) stable source of funds.¹⁷¹ Thus, it is unlikely to cause the surges in the money supply or "flight capital" that opponents had argued would result if foreign investors were to move funds around seeking the highest rate of return.¹⁷² Moreover, to the extent that dollars are shifted away from shorter-term investments, which have historically been subject to such surges, control of the money supply should become more manageable.¹⁷³ Finally, under the current system of flexible exchange rates, capital mobility is not a disadvantage; rather, it increases the efficacy of domestic monetary policy.

E. International and Domestic Tax Evasion

Some members of Congress are concerned that any increase in the use of bearer bonds—the form commonly used in the Eurobond market—will result in an increase in tax evasion by United States citizens who may attempt to pose as foreigners by setting up foreign corporations or trust arrangements.¹⁷⁴ The safeguards included in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"),¹⁷⁵ however, should be adequate to deal with such attempts at tax evasion.¹⁷⁶ Congress designed these provisions to discourage the issuance and holding of bearer obliga-

265. Query to what extent, however, the exclusion of private placements from the benefits of the repeal legislation will restrict smaller companies' access to the Eurobond market. See *supra* note 110 and accompanying text.

¹⁶⁹ See *supra* note 152.

¹⁷⁰ See *supra* note 110 and accompanying text.

¹⁷¹ *Hearings on S. 1557, supra* note 30, at 252-53 (statement of Fenton J. Burke, Esq.); *Minor Tax Bills, supra* note 14, at 91-92 ("Withholding tax discourages stable and desirable long-term investment") (statement of Nicholas Rey of the Securities Industry Association").

¹⁷² *Hearings on S. 1557, supra* note 30, at 246 (statement of Robert S. McIntyre).

¹⁷³ *Id.* at 253 (statement of Fenton J. Burke, Esq.).

¹⁷⁴ See, e.g., *May 1, 1984 Hearings, supra* note 3, at 43-45 (conversation between Rep. Dorgan and Asst. Secretary Pearlman on tax evasion concerns).

¹⁷⁵ The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324. See *supra* notes 89 and 109.

¹⁷⁶ *May 1, 1984 Hearings, supra* note 3, at 50 (statement of Ronald Pearlman of the Treasury Dept.). In addition, sec. 127(f) of the 1984 Act amends I.R.C. § 163(f)(2) and gives the Secretary broad discretion to require registration. See *supra* note 72.

tions by United States persons. Most United States obligations must now be registered in order to avoid the "issuer" and "holder sanctions"¹⁷⁷ enacted under TEFRA. Congress provided an exception to the issuer sanctions, however, for companies issuing bearer obligations in the Eurobond market.¹⁷⁸ This exception, included in I.R.C. § 163(f)(2)(B), is commonly known as the "foreign-targeted" exception to the registration requirements.¹⁷⁹ The exception is available only where (1) the issuance is designed to ensure that the obligations will be sold only to non-United States persons; (2) the interest is payable only outside the United States and its possessions and; (3) the face of the obligation bears a legend that any United States holder will be subject to the holder sanctions.¹⁸⁰ The Service has recently issued temporary regulations under the repeal legislation.¹⁸¹ These regulations incorporate and modify the TEFRA regulations, producing a formidable compliance system which will be difficult for would-be tax evaders to overcome.¹⁸²

F. Equity Considerations

The correct comparison to be made when discussing considerations of equity is that of the United States treatment of foreign investors versus the treatment accorded to United States investors by other countries.¹⁸³ Many countries currently exempt Eurobond purchasers from outside their borders from withholding taxes.¹⁸⁴ To this extent, the repeal legislation brings the United States into conformity with the tax practices of

¹⁷⁷ The sanctions imposed on an issuer of registration-required obligations not in registered form include a disallowance of the deduction for interest paid on the obligations and the imposition of an excise tax of 1% of the principal amount of the obligations. I.R.C. §§ 163(f)(1) and 4701.

The sanctions imposed upon a U.S. holder of a registration-required obligation not in registered form include a disallowance for any loss sustained on a sale or other disposition of the obligation and the requirement that any gain on the sale of the obligation be characterized as ordinary income. I.R.C. §§ 165(j) and 1287(a). *See supra* note 89.

¹⁷⁸ I.R.C. § 163(f)(2)(B).

¹⁷⁹ *Repeal of the Withholding Tax*, *supra* note 5, at 46.

¹⁸⁰ I.R.C. § 163(f)(2)(B)(i) and (ii).

¹⁸¹ *See supra* notes 82-92 and accompanying text.

¹⁸² Tax evasion will be especially difficult for holders of Treasury securities. Although Treasury initially considered issuing its obligations in bearer form, pressures from Congress on the tax evasion issue (including a nonbinding "sense of the Senate" resolution and bills prohibiting issuance of such obligations in bearer form) forced then-Secretary Regan, on August 16, 1984, to announce that the Treasury and its agencies would not issue bearer bonds. Later, on September 7, 1984, Regan announced that the issuance of any Government-backed security in bearer form would be prohibited. *See infra* notes 93-103 and accompanying text.

¹⁸³ JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 22.

¹⁸⁴ A list of those countries which do not impose withholding tax on Eurobond issues appears in the Securities Industry Association report in the 1984 hearings on the repeal legislation. *May 1, 1984 Hearings*, *supra* note 3, at 75.

those countries. Moreover, the legislation supports the longstanding principle of international taxation that portfolio investors should be subject to taxation on interest income in their own country of residence or nationality.¹⁸⁵

It is not theoretically sound to compare the United States treatment of foreign investors and the United States treatment of domestic taxpayers. This comparison, drawn by opponents of the legislation, suggests that it is inequitable to exempt foreigners from withholding taxes on interest when United States taxpayers have to pay taxes on domestic interest income at rates of up to fifty percent.¹⁸⁶ There are several arguments to refute this charge. First, the United States taxpayer receiving domestic interest income clearly derives benefits from residing in the United States that the foreign investor does not.¹⁸⁷ Second, although the maximum tax rate that a United States taxpayer pays on domestic interest income is as high as fifty percent, deductions against this income are allowed so that the effective tax rate may be far below fifty percent. The foreign investor, conversely, is not allowed any deductions against the thirty percent withholding tax, so that his effective tax rate is often higher than that of a United States taxpayer.¹⁸⁸

Finally, opponents argue that foreigners are "privileged" to invest in United States assets and, accordingly, should pay a tax for this privilege.¹⁸⁹ This argument is without merit. No one would suggest that an individual should charge his or her bank a fee for the privilege of lending to him or her.¹⁹⁰ The foreigner's investment in United States assets is no more than a loan to a United States corporation or the federal government.

¹⁸⁵ Treaties which grant an exemption on interest income relinquish their "source" jurisdiction and give taxing jurisdiction to the investor's country of residence. See Article XI of the U.S. Treasury Dept. Model Income Tax Treaty (Jun. 16, 1981). See also 1976 *Hearings on Foreign Investment*, *supra* note 39, at 5, 24, 36 (discussions by panelists on their views as to the appropriate method of taxing foreigners on their interest income earned in other countries).

¹⁸⁶ This argument was advanced as early as 1975 by members of Congress who opposed the repeal legislation. See 122 CONG. REC. 23,877 (1976) (statement of Sen. Kennedy) and 121 CONG. REC. 38,287 (1975) (statement of Rep. Fisher).

¹⁸⁷ The U.S. taxpayer receives services from the federal government and the protection of U.S. laws. Thus, a cost/benefit analysis can be applied to this relationship. The application of such an analysis in the case of interest income paid to a foreign investor is much more problematic. Accordingly, treaties generally exempt such income from source withholding. D. TILLINGHAST, *TAX ASPECTS OF INTERNATIONAL TRANSACTIONS* 5-6 (2d ed. 1984).

¹⁸⁸ CRS STUDY, *supra* note 16, at 8.

¹⁸⁹ Senator Packwood advanced this argument in the early debates on the repeal legislation. 122 CONG. REC. 23,876 (1976).

¹⁹⁰ 122 CONG. REC. 23,877 (1976) (statement of Sen. Brock).

G. Treaty Negotiations and Treaty Shopping

Some experts believe that treaty shoppers, tax evaders and suspected drug criminals have historically used the U.S.-N.A. treaty to avoid taxation or detection by United States authorities. This, they feel, has been made possible by the Antillean government's lack of strong law enforcement, its reliance on the revenues that these activities generate, and its status as a "tax haven."¹⁹¹ For more than four years, the United States has been trying to strengthen certain provisions of the treaty so as to require greater surveillance by the Antillean government and information exchange between the countries. Prior to the passage of the repeal legislation, the United States was having difficulty renegotiating the U.S.-N.A. treaty because the treaty contained exemptions allowing United States companies to access the Eurobond market through the Antillean finance subsidiary system.¹⁹² The United States government was reluctant to terminate or jeopardize this access. Now that United States companies are no longer dependent upon the U.S.-N.A. treaty, however, negotiators can work either to eliminate the treaty shopping and other abuses that take place through the treaty, or, if negotiations are unsuccessful, they can terminate the treaty.¹⁹³ It is estimated that almost \$1 billion in annual tax revenues goes uncollected as a result of abuses of this tax haven treaty.¹⁹⁴ Thus, the repeal legislation may allow the United States to indirectly recoup these losses by strengthening the United States position in these treaty negotiations.

Opponents of the repeal legislation contend that the legislation represents a unilateral concession of a valuable "bargaining chip": the reduction in the thirty percent withholding tax on interest. They note that, prior to the repeal legislation, countries negotiated such reductions on a reciprocal basis. Thus, they contend that the United States has thrown away this negotiating tool without receiving any *quid pro quo*.¹⁹⁵ The United States will not, however, be placed in a disadvantageous bargaining position in all treaty negotiations by having unilaterally granted this

¹⁹¹ *Hearings on Tax Evasion*, *supra* note 34, at 570-71. While there is no standard definition of a "tax haven," most definitions are similar to that of the Treasury Department: "any country having a low or zero rate of tax on all or certain categories of income, and offering a certain level of banking or commercial secrecy." *TAX HAVENS*, *supra* note 34, at 14.

¹⁹² The reluctance of the United States to terminate treaty negotiations with the Antillean government stemmed from the realization that the closing of the Eurobond window would have a detrimental effect on the U.S. financial markets. The presentation of the Securities Industry Association in the 1984 hearings includes a discussion of those effects, most notably those of "crowding out" and a rise in interest rates. *May 1, 1984 Hearings*, *supra* note 3, at 72-74.

¹⁹³ *Id.* at 92 (statement of John Gunner of the U.S. General Accounting Office).

¹⁹⁴ 129 CONG. REC. E4643 (daily ed. Sept. 29, 1983) (statement of Rep. Barnard).

¹⁹⁵ 122 CONG. REC. 23,874 (1976) (statement of Sen. Packwood).

concession. First, it is questionable whether reciprocal elimination of the withholding tax on interest income has ever been truly effective in gaining concessions in treaty negotiations.¹⁹⁶ Second, there are many other forms of income to which the withholding tax still applies and which can be utilized as "bargaining chips" in the treaty negotiation process if so desired.¹⁹⁷

H. Foreign Policy Aspects

The repeal legislation eliminates the need for United States companies to utilize the foreign finance subsidiary structure that previously flourished in the Netherlands Antilles. Therefore, it is likely that the legislation will cause some hardship to the Antillean economy, which relies upon its financing sector for approximately twenty-five percent of the country's gross national product.¹⁹⁸ As evidence of concern for the Antillean economy, however, Congress provided for direct Eurobond access only on obligations issued after July 18, 1984.¹⁹⁹ Issues in existence on that date will continue to be serviced through the Antillean finance subsidiary structure. This provision should allow the Antillean economy some time to adjust to the effects of the legislation and to develop other sources of revenue for the future.²⁰⁰

The repeal legislation may also result in retaliatory action by foreign governments who, in order to compete with the United States for funds, may be forced either to enact similar legislation or to increase the interest rates that they currently pay.²⁰¹ To this extent, opponents argued, the effect of the repeal legislation would be neutralized, and only the foreign investor would gain. This has not, however, proven to be true. Although some governments have, in fact, enacted similar legislation, their actions have not reduced the capital flowing to the United States, largely because

¹⁹⁶ Governments are not generally interested in having their citizens invest in other countries' assets. Thus, in most cases, reciprocal elimination or reduction of the withholding tax is not eagerly sought by those governments. *Minor Tax Bills*, *supra* note 14, at 134 (statement of John Hennessy of First Boston Corp.).

¹⁹⁷ JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 23.

¹⁹⁸ *May 1, 1984 Hearings*, *supra* note 3, at 119 (statement of Prime Minister Dominico Martina). Economic data in the hearings also indicated that the subsidiary financing industry was one of the four "pillars" of the Antillean economy. Repeal of the withholding legislation, the prime minister said, would (1) cost the United States a half-billion dollars over the next 5 years; (2) destabilize the Netherlands Antilles by reducing revenues and increasing unemployment (from 20 to 27%); and (3) conflict with the goals of the Administration's Caribbean Basin Initiative. *Id.* at 119-25.

¹⁹⁹ See *supra* note 59 and accompanying text.

²⁰⁰ EXPLANATION OF THE 1984 ACT, *supra* note 6, at 392-93.

²⁰¹ *May 1, 1984 Hearings*, *supra* note 3, at 94 (statement of John Gunner of the U.S. General Accounting Office).

of the relative attractiveness of United States securities.²⁰²

I. Revenue Effects

The short and long-term effects of the repeal legislation on government revenues were, and remain, difficult to estimate. Revenue estimates on the repeal legislation varied widely, depending on the source of the estimate and on the proposal being analyzed.²⁰³ It was generally acknowledged, however, that the following would result:

- (1) The direct effect of repeal would be the loss of whatever was being

²⁰² Since the repeal legislation became effective, Great Britain, France and West Germany have all taken steps to exempt foreign investors from any withholding tax on interest paid on government securities. See *infra* note 213.

²⁰³ Treasury originally estimated a revenue gain of \$35 to 50 million annually from repeal under H.R. 3025. *Revenue Increase Proposals*, *supra* note 41, at 295. Problems in making such predictions arose from the following assumptions which had to be made as to existing expenditures:

- (1) That the U.S. corporations and their Antillean finance subsidiaries were entitled to the benefits they were deriving under the treaty;
- (2) That U.S. taxpayers were paying creditable income taxes to the Netherlands Antilles;
- (3) That U.S. parents of Antillean finance subsidiaries would dissolve the subsidiaries on enactment of the bill.

However, as the Treasury noted, it was not clear that the bill would cause taxpayers to claim less foreign tax credits and thus, perhaps no indirect revenue increase would result. JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 30-31.

Members of the securities industry predicted even higher gains from passage of H.R. 3025 and H.R. 4029. During the earlier hearings on H.R. 3025 (when the industry painted a united front), members of the industry called the Treasury's estimate of \$35 to 50 million annual revenue gain "conservative," and stated that they believed that the actual net revenue gain would more likely be twice that amount. *Revenue Increase Proposals*, *supra*, note 41, at 319.

During the 1984 hearings on H.R. 3025 and H.R. 4029, however, the Treasury (which favored H.R. 3025) and the faction of the securities industry which favored the narrow repeal of H.R. 4029 put forth disparate revenue figures. The Treasury, assuming that the passage of the foreign tax credit provisions would prevent resourcing of interest income compiled the following estimates:

		Summary of years 1984-87 revenue effect (millions)
Gibbons-Conable	(H.R. 3025)	+23
Barnard	(H.R. 4029)	+166
Senate Bill	(sec. 142—phase-in)	+211

May 1, 1984 hearings, *supra* note 3, at 35.

Proponents of the narrow version of repeal, H.R. 4029 (which would have excluded the issues of the federal government from the favorable interest exemption), contended that H.R. 4029 would increase tax revenues by "at least \$875 million over the next 6 years compared to the broad form of repeal." This estimate assumed that the broad version of repeal would eliminate withholding on assumed issues (*i.e.* those currently outstanding). *May 1, 1984 hearings*, *supra*, note 3, at 244. The repeal legislation does not, however, extend to obligations in existence prior to the Act's effective date. Deficit Reduction Act of 1984, sec. 127(g)(1). Moreover, the estimate made by the proponents of H.R. 4029 did not take into account the savings that would accrue to the federal government under H.R. 3025 from the government's ability to finance the \$1.5 trillion dollar public debt at lower interest rates. This factor could add almost \$1 billion to the revenues produced by H.R. 3025 (using 1/18 of 1% as the savings in interest). *May 1, 1984 Hearings*, *supra* note 3, at 103.

currently withheld. For 1982, this amount was \$152 million.²⁰⁴

- (2) Indirectly, revenues would be generated by eliminating the foreign tax credits which United States companies claimed for taxes paid to the Netherlands Antilles.²⁰⁵
- (3) While there would be additional revenue gains from increased United States employment and investment,²⁰⁶ there would also be offsetting losses from declines in exports and increases in interest expense, Accelerated Cost Recovery deductions and investment tax credits.²⁰⁷

The Joint Committee on Taxation recently estimated that the repeal legislation, as enacted, will lose \$162 million in fiscal years 1984-1987, although the committee has not disclosed its assumptions or methods of computation.²⁰⁸ It appears, however, that this estimate does not take into account the revenues to be generated by the changes in the foreign tax credit, as these changes are accounted for under a separate section of the 1984 Act.²⁰⁹

V. CONCLUSION: EFFECTS OF THE REPEAL LEGISLATION TO DATE AND OUTLOOK FOR THE FUTURE

Although a study done for Congress on the repeal legislation predicted a small impact on the strength of the dollar and the government's revenues,²¹⁰ evidence to date suggests that the repeal in fact, contributed to an all-time high valuation of the dollar during 1984.²¹¹ In some circles, this result has been criticized because of its adverse effects on the balance of trade and the cost of exports.²¹² In addition, reactions of foreign governments suggest that the legislation was not a boon to foreign relations. Both France and West Germany recently repealed their withholding rates on interest paid to foreigners in order to compete success-

²⁰⁴ JOINT COMMITTEE PRINT OF 1984, *supra* note 20, at 30.

²⁰⁵ *Id.*

²⁰⁶ *Hearings on S. 1557, supra* note 30, at 245 (statement of Michael H. Coles of Goldman, Sachs & Co.).

²⁰⁷ *Joint Committee Print of 1984, supra* note 20, at 31.

²⁰⁸ EXPLANATION OF THE 1984 ACT, *supra* note 6, at 1242.

²⁰⁹ The foreign tax credit provisions and their revenue effects are dealt with under § 121 of the 1984 Act. *Id.* at 1241.

²¹⁰ CRS STUDY, *supra* note 16, at 35-37.

²¹¹ 24 TAX NOTES 326 (Jul. 23, 1984). On December 31, 1984, the dollar set an 11½ year high of 3.1550 marks, a 2-year high of 251.85 yen and matched a previous high of 9.6450 French francs. For the first time, the British pound fell below \$1.16, to \$1.1583. *Wall St. J.*, Jan. 2, 1985, at 8, col. 3. During 1985, however, the dollar returned to lower levels. As of November 15, 1985, for example, the dollar was valued at 2.6225 marks, 204.20 yen and 7.9950 French francs, while the pound was valued at \$1.4225. *Wall St. J.*, Nov. 15, 1985, at 53, col. 3.

²¹² See Testimony of Robert S. McIntyre before the Committee on Ways & Means, *May 1, 1984 Hearings, supra* note 3, at 237.

fully for the pool of available foreign capital,²¹³ and Japan recently indicated its intent to do the same on Euroyen bonds.²¹⁴ In light of these developments, some members of Congress are seeking to reevaluate the withholding legislation as a tool for regulating the value of the dollar. In addition, the monitoring of potential tax evasion on Eurobond issues continues in at least one House subcommittee.²¹⁵

Despite these setbacks, it is clear that the repeal legislation has been successful in accomplishing the purpose for which it was enacted—raising capital. In the first quarter of 1985 alone, United States companies raised a record \$9.4 billion in the foreign bond market.²¹⁶ This figure compares favorably with a monthly rate of \$1.5 billion in 1984, a record at that time. These capital flows should result in lower domestic interest rates and, thus, should spur additional corporate investment in productive activities.

The results of a recent study on the effects of the 1975 removal of the Canadian withholding tax²¹⁷ reinforce this view. That study concluded that removal of the withholding tax resulted in statistically significant higher capital flows to the country and lower interest rates. The lower interest rates also strengthened the corporate tax base, resulting in higher revenues for the Canadian Treasury. While differences between the United States and the Canadian economy may prevent a direct comparison in results, the thrust of the study seems applicable in light of the United States experience. With the ability to attract such impressive amounts of capital, corporations will be able to increase production and

²¹³ The battle for the world savings has resulted from a shift in financial flows. Although from 1970-1978, the United States exported a net \$76 billion in capital, the trend has reversed since 1978. From 1979-1983, the United States borrowed a net \$150 billion.

In order to compete for its share of world savings, France, on October 3, 1984, agreed to eliminate the 26% withholding tax on interest paid to foreign investors. On the same day, West Germany agreed to enact legislation to abolish its 25% withholding tax retroactive to August 1, 1984. Great Britain has also begun to use a mechanism whereby certain bond issuances will be deemed tax-free on an issue-by-issue basis. On August 16, 1984, the British government issued a \$1.2 billion tax-free bond. Observers contend, however, that these measures will not counteract the effect of the U.S. repeal legislation. This is probably because U.S. issues are considered much more stable than those of most other countries. 25 TAX NOTES 275-76 (Oct. 15, 1984).

²¹⁴ On January 7, 1985, Japanese and U.S. officials concluded talks in which the Japanese agreed to submit to their Diet a proposal to repeal the 20% withholding tax on interest paid to nonresidents on Euroyen bonds issued by Japanese residents. Report of the MOF/Treasury Working Group on Withholding Taxes, Jan. 7, 1985, reprinted in 26 TAX NOTES 232 (Jan. 21, 1985).

²¹⁵ Rep. Doug Barnard, Chairman of the Consumer, Commerce & Monetary Affairs Subcommittee of the House Government Operations Committee, plans to monitor compliance with the provisions of the Act and the regulations through his committee. 24 TAX NOTES 325 (Jul. 23, 1984).

²¹⁶ 65 DEP'T OF COMM, SURV. CURRENT BUS. 38 (1985)

²¹⁷ Breaun, *International Portfolio Capital: The Wedge of the Withholding Tax*, 37 NAT'L TAX J. 239 (1984).

employment. The federal government will lower its borrowing costs by millions. The repeal of the withholding tax will indeed prove itself to have been "a capital idea."

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