[JOINT COMMITTEE PRINT]

DESCRIPTION OF H.R. 7553

RELATING TO

EXEMPTIONS FROM U.S. TAX FOR INTEREST PAID TO FOREIGN PERSONS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON JUNE 19, 1980

PREPARED FOR THE USE OF THE

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INTRODUCTION

This pamphlet provides a description of H.R. 7553 and a Senate Finance Committee amendment to H.R. 2297 relating to the withholding tax on interest paid to foreign investors. The Subcommittee on Select Revenue Measures of the Committee on Ways and Means has scheduled a public hearing on this subject on June 19, 1980.

The first part of the pamphlet is a summary of present law and current legislative proposals. This is followed by a discussion of present law and background relating to the proposals. The fourth part is a description of legislative proposals, including a summary of prior Congressional consideration. The last part is a discussion of issues involved in the proposals.

I. SUMMARY

Under present law, a U.S. withholding tax of 30 percent is generally imposed on annuities, interest, dividends, rents, royalties, and similar payments by U.S. persons to foreign investors if the payments are not effectively connected with a U.S. trade or business. Exemptions from the withholding tax are provided in certain situations. In addition, U.S. tax treaties generally reduce or eliminate the withholding tax on interest paid to treaty country residents.

The bill, H.R. 7553, would repeal the 30-percent withholding tax on interest paid to foreign investors on portfolio indebtedness. The withholding tax on interest paid to foreign investors would generally be limited to situations where the foreign investor is related to the U.S. obligor or where the foreign investor is controlled by U.S. persons. Obligations, the interest on which is exempt under the bill, would also be exempt from U.S. estate and gift tax. No exemptions from U.S. tax would be provided unless the foreign lenders disclosed their identities to the IRS.

The provisions of H.R. 7553 would be effective for interest paid after the date of enactment of the bill.

H.R. 7553 is substantively identical to a Senate Finance Committee amendment to H.R. 2297 as reported.

II. PRESENT LAW

In general

The United States taxes the income of U.S. citizens, residents, or corporations whether that income is from U.S. sources or abroad (in the case of foreign source income, however, a dollar-for-dollar credit is allowed for any foreign income tax paid). In the case of nonresident aliens and foreign corporations, however, the United States generally only taxes their income which is from U.S. sources.

Withholding tax on foreign investors

In situations where the U.S. source income received by the nonresident alien or foreign corporation is interest, dividends, or other similar types of investment income, the United States imposes a flat 30-percent tax on the gross amount paid (subject to reduction in rate or exemption by U.S. tax treaties, as described below) if such income or gain is not effectively connected with the conduct of a trade or business within the United States (Code secs. 871(a) and 881). This tax is generally collected by means of withholding by the person making the payment to the foreign recipient of the income (Code secs. 1141 and 1442) and, accordingly, the tax is generally referred to as a withholding tax. In most instances, the amount withheld by the U.S. payor is the final tax liability of the foreign recipient and thus the foreign recipient files no U.S. tax return with respect to this income. If the interest, dividend, or other similar income is effectively connected with a U.S. trade or business, that income is not subject to the flat 30-percent withholding tax on gross income, but instead is included in the U.S. income tax return which must be filed for the business and is taxed at the ordinary graduated rates.

Exemptions from the withholding tax

A number of exemptions have been provided from this 30-percent tax on gross income. Interest from deposits with persons carrying on the banking business and similar institutions is exempt (Code secs. 861(a)(1)(A) and 861(c)). Original issue discount on obligations maturing in six months or less is exempt (Code secs. 871(a)(1) (A) and (C) and 881(a) (1) and (3)). Any interest and dividends paid by a domestic corporation which earns less than 20 percent of its gross income from sources within the United States is also not subject to the 30-percent tax (Code secs. 861(a) (1) (B) and 861(a) (2) (A)). Under the expired interest equalization tax (IET), interest on certain debt obligations which were part of an issue with respect to which an election had been made for IET purposes is exempt (secs. 861(a) (1) (G) and 4912(c) of the Code).

The income of foreign governments from investments in the United States in bonds, stocks and other securities, or from interest on bank deposits, is exempt from U.S. tax (Code sec. 892). The Treasury promulgated proposed regulations under this provision on August 15,

1978. The proposed regulations, while generally allowing an exemption, would deny the exemption for income which the foreign government receives from commercial activities in the United States or income which accrues to the account of any private person. Although interest received by a foreign government might not qualify for the statutory exemption for foreign governments, such amounts might be eligible for other exemptions (such as that available for interest on bank accounts).

There is no estate tax liability with respect to a debt obligation or a bank deposit if the interest on such obligation or deposit would not be subject to the 30-percent withholding tax if it were received by the decedent at the time of his death (Code secs 2.104 and 2105).

Tax treaty exemptions

In addition to the above exemptions provided in the Internal Revenue Code, various income tax treaties of the United States provide either for an exemption or a reduced rate of tax for U.S. source interest paid to foreign persons. The exemption or reduction in rate only applies if the income is not attributable to a trade or business conducted in the United States through a permanent establishment or fixed base located in the United States. It is generally the negotiating position of the United States, as expressed in Article 11 of the Treasury's model income tax treaty, to exempt interest from withholding unless the income is effectively connected with a permanent establishment or fixed base. The treaty exemption is based on the assumption that the interest income will be taxed in the country of residency in any event. Interest generally is exempt under treaties with Austria, Denmark, Finland, Germany, Greece, Hungary, Iceland, Ireland, Luxembourg, Malawi, Netherlands, Netherlands Antilles, Norway, Poland, Sweden, U.S.S.R., United Kingdom, and Zambia. Reciprocal reductions in rate are provided under treaties with Belgium, Burundi, Canada, Rwanda, and Zaire (15 percent), Korea (12 percent), France, Japan, and Romania (10 percent), and Switzerland (5 percent).

Treaty shopping.—Although the treaty exemptions are only intended to benefit residents of the treaty country, it has been possible, as a practical matter, for investors from other countries to obtain the benefits of those treaties providing an exemption from U.S. tax on U.S. source interest income. Investors from countries which do not have tax treaties with the United States, or from countries which have not agreed in their tax treaty with the United States to a reciprocal exemption of interest (e.g., Canada and France), can effectively secure the exemption by routing their loan through a country having a treaty with the United States containing the interest exemption. This is accomplished by establishing a subsidiary, trust, or other investing entity in the treaty country which makes the loan to the U.S. person and claims the treaty exemption for the interest it receives. If the investment entity is established in the appropriate country, it may be possible for the investing entity in turn to pay the interest to the foreign investor or to a tax haven without any tax liability to the recipient and eliminating or minimizing the investing entity's tax liablity with the deduction for its interest payment. This use of U.S. tax treaties by third country investors to avoid any tax on the interest income rather than to avoid a potential double tax is referred to as "treaty shopping." As discussed below, a more important treaty shopping use of U.S. tax treaties is the use by U.S. corporations of the U.S. treaty applicable to the Netherlands Antilles (and, in a few cases, the treaty applicable to the British Virgin Islands or to Luxembourg) to obtain an exemption from U.S. tax on interest paid to foreign investors on bonds issued by the U.S. corporations through Antilles (or BVI or Luxembourg) finance subsidiaries.

Reporting of interest

U.S. corporations are generally required to file information returns to report the payment of interest (including original issue discount) of $10 or more. Nominees are also generally required to file reports with respect to interest received and passed along to the beneficial owners. One copy of the return is required to be sent to the recipient of the interest and another copy is sent to the Internal Revenue Service.

Returns are required to be made for amounts paid on corporate indebtedness if the obligation is in registered form. The Code (sec. 6049(b)(1)(A)) also authorizes the Treasury to require reporting with respect to amounts paid on other corporate debt of a type offered by corporations to the public (e.g., a public offering of bearer bonds). However, no such reporting is presently required. Also, no information reporting is required in the case of interest or original issue discount paid to foreign investors if withholding tax is imposed on the payment or if withholding tax would be imposed but for an exemption from withholding because the amounts are eligible for a treaty exemption, the exemption for deposits with banks, because they are effectively connected with a U.S. trade or business or if certain other limitations apply. (Code sec. 6049(b)(2)(B); Treas. Reg. § 1.6049-2(b)(3)).

Withholding and identification of interest recipient

As described above, withholding is generally required when interest is paid to a foreign investor. The Code (secs. 1441(c)(2) and 1442(a)) authorizes the Treasury to require this withholding in any situation in which the beneficial owner of securities on which the interest is paid is unknown to the withholding agent. This authority has been exercised generally to require withholding in all such situations (Treas. Reg. § 1.1441-3(c)(4).) In addition, Form 1042S must be provided by the withholding agent to the payee when amounts have been withheld.

In order to secure a treaty exemption from U.S. withholding tax on U.S. source interest income, a foreign resident must file (or the resident's trustee or agent receiving the interest income must file on his behalf) IRS Form 1001 (Ownership, Exemption, or Reduced Rate Certificate). Form 1001 requires the disclosure of the identity and address of the owner of the bond. In the case of a bearer bond, the form must be presented to the payor by or on behalf of the foreign owner with each coupon.

Even where the foreign investor presenting an interest coupon on a corporate bond is not entitled to a treaty rate reduction or exemption, the foreign investor is nevertheless still required to present, with each such coupon, a certificate of ownership on Form 1001. (The information required by that form is described above.) Where the owner of the bond is unknown to the person presenting the coupons for payment, the regulations further provide that the first bank to which the coupons are presented for payment is to require of the payee a statement showing the name and address of the person from whom the coupons were received by the payee. (Treas. Reg. § 1.1461–1.)

III. BACKGROUND

The Eurobond Market

A major capital market outside the United States is the Eurobond market. It is not an organized exchange, but rather a network of underwriters and financial institutions who market bonds issued by private corporations (including but not limited to finance subsidiaries of U.S. companies—see discussion below), foreign governments and government agencies, and other borrowers. In addition to individuals, purchasers of the bonds include institutions such as banks (frequently purchasing on behalf of investors with custodial accounts managed by the banks), investment companies, insurance companies, and pension funds. There is a liquid and well-capitalized secondary market with rules of fair practice enforced by the Association of International Bond Dealers. Although a majority of the bond issues in the Eurobond market are denominated in dollars (whether or not the issuer is a U.S. corporation), bonds issued in the Eurobond market are also frequently denominated in other currencies (even at times when issued by U.S. multinationals).

In general, debt securities sold in the Eurobond market are free of taxes withheld at source, and the form of bond, debenture, or note sold in the Eurobond market puts the risk of such a tax on the issuer by requiring the issuer to pay interest, premium, and principal net of any tax which might be withheld at source (subject to a right of early call in the event that a withholding tax is imposed as a result of a change in law or interpretation occurring after the obligations are issued). U. S. multinational corporations issue bonds in the Eurobond market free of U.S. withholding tax through the use of finance subsidiaries, almost all of which are incorporated in the Netherlands Antilles. Foreign issuers offer bond issues not subject to withholding tax in their home jurisdiction either through foreign finance subsidiaries (e.g., Germany) or through specific statutory exemptions. In some cases, the statutory exemptions apply to interest paid to foreign investors generally (e.g., Norway and Sweden) or, more frequently, the exception is contingent on the bond being issued in a foreign currency (e.g., Australia, Canada, and Japan). Because the Eurobond market is comprised of bonds not subject to withholding tax by the country of source, an issuer could not compete for funds in the Eurobond market if its interest payments were subject to withholding tax.

Unlike bonds issued in the U.S. capital market, Eurobonds are issued in bearer (rather than registered) form so that the interest and principal payments must be effected by presenting the coupons or bonds to a designated paying agent. Since the bonds are issued in bearer form, the anonymity of the holder of the bond is protected—the holder's identity is not disclosed to the issuer or to the government of the country of issue.

International finance subsidiaries

Borrowing abroad (such as on the Eurobond market) by U.S. corporations is generally accomplished through the use of finance subsidiaries. Finance subsidiaries are usually paper corporations without employees or fixed assets which are organized to make one or more offerings in the Eurobond market, with the proceeds to be relent to the U.S. parent or to domestic or foreign affiliates. The interest and principal on the bonds issued by the finance subsidiary are guaranteed by its parent. Their use (described below) is intended to avoid any U.S. withholding taxes on the interest paid to the foreign bondholders.

If the money raised is to be utilized abroad, the parent corporation will sometimes form a U.S. finance subsidiary through which it issues the bonds. As noted earlier, even though the borrower (the finance subsidiary) is a U.S. corporation, interest paid by it to foreign lenders will be treated as foreign source income, and hence will not be subject to withholding, if less than 20 percent of the finance subsidiary's gross income is from U.S. sources. This gross income requirement usually is met if the U.S. finance subsidiary invests the borrowed funds in the foreign operations of the corporate group.

On the other hand, the most common practice of borrowers, particularly if the borrowed funds are to be used in the United States, is to establish a finance subsidiary in the Netherlands Antilles. This structure is designed to avoid the U.S. withholding tax by claiming the benefits of the tax treaty between the United States and the Netherlands as extended to the Antilles. The subsidiary borrows funds from foreign lenders, and the subsidiary then relends the borrowed funds to the parent or to other affiliates within the corporate group. The finance subsidiary's indebtedness to the foreign bondholders is guaranteed by the U.S. parent (or other affiliates) or is secured by notes of the U.S. parent (or other affiliates) issued to the Antilles subsidiary in exchange for the loan proceeds of the bond issue. Under this arrangement, the U.S. parent (or other U.S. affiliate) receives the proceeds of the bond issue but pays the interest to the Antilles finance subsidiary rather than directly to the foreign bondholders. Pursuant to Article VIII of the treaty, an exemption is claimed from the U.S. withholding tax on the interest payments by the U.S. parent and affiliates to the Antilles finance subsidiary. The interest payments which the Antilles subsidiary in turn pays to the foreign bondholders are not subject to tax by the Antilles. Although most or all of the income of the Antilles finance subsidiary is comprised of interest payments from its U.S. parent and affiliates, that interest income would not ordinarily be treated as effectively connected with a U.S. trade or business of the Antilles subsidiary. Consequently, since less than 50 percent of the gross income of the Antilles finance subsidiary is effectively connected with a U.S. trade or business, no part of the interest paid by the Antilles finance subsidiary to the foreign bondholders would be considered to be from U.S. sources and, accordingly, no U.S. withholding tax would be imposed.[1] Thus, no tax is paid on the interest paid by the U.S. company to its Antilles finance subsidiary, or on the interest paid by the Antilles finance subsidiary to the foreign bondholders, either to the United States or to the Netherlands Antilles. Use of a foreign subsidiary may also increase the parent's ability to utilize foreign tax credits by converting the net income of the subsidiary into foreign source income.

Borrowings by U.S. corporations in the Eurobond market were originally a result of a program adopted by the U.S. Government during the 1960s at a time of fixed exchange rates. The program, designed to prevent the devaluation of the dollar, included several measures to encourage U.S. companies to borrow overseas, including the Interest Equalization Tax, the Foreign Direct Investment Program, the related Voluntary Foreign Credit Restraint Program, a relaxation of the no-action letter policy of the Securities and Exchange Commission with respect to foreign offerings by U.S. corporations, and the ruling policy of the IRS which encouraged foreign borrowings through finance subsidiaries. In the case of finance subsidiaries, domestic or foreign, the IRS was prepared to issue private rulings that no U.S. withholding tax applied if the ratio of the subsidiary's debt to its equity did not exceed 5 to 1 and certain other conditions were met. Numerous private rulings were issued on this basis. Finance subsidiaries were also sanctioned by a number of published rulings (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).

Following the decision by the United States to abandon the fixed exchange rate system and to allow the value of the dollar to be determined by market forces—with the consequent termination of these measures to support the dollar—Eurobond offerings by U.S. corporations decreased. This decrease was in large part due to questions as to whether finance subsidiaries qualify for the exemption from the U.S. withholding tax, questions which arose when the IRS, citing the expiration of the IET, revoked its prior rulings that properly structured finance subsidiaries would qualify (Rev. Rul. 74–464, 1974–2 C.B. 46). Because of a finance subsidiary's limited activities, the lack of any significant assets or earning power other than the parent guarantee and the notes of the parent and other affiliates, and the absence of any substantial business purpose other than the avoidance of U.S. withholding tax, offerings by finance subsidiaries involve difficult U.S. tax issues in the absence of favorable IRS rulings. Since the marketing of the bond offering is based upon the reputation and earning power of the parent, and since the foreign investor is ultimately looking to the

[1] Even if the income of the finance subsidiary (the interest it receives from its U.S. parent and affiliates) were treated as effectively connected with a U.S. trade or business, the interest paid by the Antilles finance subsidiary would nevertheless be exempt from U.S. tax under Article XII of the treaty. This situation is advantageous when the taxpayer is in an excess foreign tax credit position because, while subject to U.S. tax on its net income (the spread between the interest it receives and the amounts it pays to the foreign bondholders), the finance subsidiary is not required to make an election to be subject to Netherlands Antilles tax in order to be free of the U.S. withholding tax.

U.S. parent for payment of principal and interest, there is a risk that the bonds might be treated as, in substance, debt of the parent, rather than the subsidiary, and thus withholding could be required. (This risk would appear to increase where, as is sometimes the case, the bonds are convertible into stock of the parent.) Compare, e.g., *Aiken Industries, Inc.*, 56 T.C. 925 (1971) and *Plantation Patterns, Inc.* v. *Commissioner*, 462 F.2d 712 (5th Cir. 1972), 72–2 U.S.T.C. ¶ 9494, *cert. denied*, 406 U.S. 1076, with *Moline Properties*, 319 U.S. 436 (1943), 43–1 U.S.T.C. ¶ 9464 and *Perry R. Bass*, 50 T.C. 595 (1968). Alternatively, the establishment of the finance subsidiary might be viewed as having as its principal purpose the avoidance of the withholding tax on the U.S. parent with the result that the exemption might not apply (Code sec. 269). Nevertheless, these finance subsidiary arrangements do in form satisfy the requirements for an exemption from the withholding tax and there are a number of legal arguments which would support the taxation of these arrangements in accordance with their form. In any event, notwithstanding the refusal of the IRS since 1974 to issue rulings with respect to Antilles finance subsidiaries, it is understood that the IRS has not to date challenged these arrangements and many bond issues have been issued since 1974 (with the number of issues increasing in recent years) on the basis of opinions of counsel.[2]

Typically, the U.S. parent and the finance subsidiary agree to indemnify the foreign bondholder against all U.S. withholding taxes (including interest and penalties) should the IRS successfully attack the claimed exemption from U.S. withholding tax or should U.S. tax law or the tax treaty with the Netherlands Antilles be changed to eliminate the basis for the claimed exemption. Also, the bonds typically provide that if U.S. withholding tax is imposed, the bonds are immediately callable.

Table of interest paid and tax withheld

The following table shows portfolio interest and withholding on that income for 1977, based on information returns filed with the Internal Revenue Service. The information is arranged according to the payee's country of address, which is not necessarily his country of residence.

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[2] For detailed discussions of Eurobond financings through finance subsidiaries and of the legal issues presented, see Lederman, *The offshore subsidiary: An analysis of the current benefits and problems*, 51 Journal of Taxation 86 (August 1979), and Chancellor, *Eurobond Financings*, U. So. Cal. 1971 Tax Inst. 345 (1971).

Portfolio Interest Paid to Foreign Persons and U.S. Tax Withheld—1977

(Money amounts in thousands of dollars)

Country	Interest paid		U.S. tax withheld		Effective withholding rate (percent)
	Amount paid	Percent of total	Amount withheld	Percent of total	
Antigua	2, 970	(*)	0	(*)	0. 0
Australia	674	(*)	192	(*)	28. 5
Bermuda	1, 809	(*)	473	1. 9	26. 1
Belgium	9, 820	1. 9	1, 220	5. 0	12. 4
Canada	129, 461	25. 1	9, 195	37. 6	7. 1
France	30, 150	5. 8	2, 785	11. 4	9. 2
West Germany	6, 515	1. 3	107	(*)	1. 6
Hong Kong	1, 814	(*)	313	1. 3	17. 3
Ireland	309	(*)	21	(*)	6. 8
Italy	3, 894	(*)	352	1. 4	9. 0
Japan	36, 237	7. 0	2, 073	8. 5	5. 7

Luxembourg	4,232	(*)	129	(*)	3.1
Mexico	2,261	(*)	617	2.5	27.3
Netherlands	29,691	5.8	26	(*)	0.1
Netherlands Antilles	97,026	18.8	77	(*)	0.1
Panama	2,618	(*)	465	1.9	17.8
Puerto Rico	281	(*)	75	(*)	26.7
Switzerland	61,908	12.0	2,820	11.5	4.6
United Kingdom	28,359	5.6	283	1.6	1.0
United States	1,825	(*)	14	(*)	0.8
Venezuela	2,356	(*)	112	(*)	4.8
Subtotal	454,290		21,349		4.7
All other countries	61,128		3,038		5.0
Total	**515,418**		**24,432**		**4.7**

*Less than 1 percent of total. Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

IV. LEGISLATIVE PROPOSALS

A. Prior Congressional Action

In connection with its consideration of the Tax Reform Act of 1976, the Committee on Ways and Means voted to repeal the 30-percent withholding tax on both interest and dividends. However, this provision was removed from the bill by the House of Representatives by a vote of 301–119. The Senate Finance Committee proposed an amendment which would have repealed the 30-percent tax on interest only. However, this amendment was deleted from the bill on the Senate floor by a vote of 54–34.

B. H.R. 7553 and Senate Finance Committee Amendment to H.R. 2297

On December 15, 1979, the Senate Finance Committee reported H.R. 2297 (which, as passed by the House, would have repealed the tariff on synthetic rutile, a substance used in the refining of titanium) with several amendments, including an amendment relating to the 30-percent withholding tax on interest.[1] H.R. 7553, as introduced, is identical to the provisions of H.R. 2297 repealing the U.S. withholding tax on interest paid to foreign lenders. The provisions of these two bills are described below.

Description of provisions

Withholding tax

Under H.R. 7553 and the Finance Committee amendment to H.R. 2297, interest paid by a U.S. borrower would generally be exempt from U.S. tax (under Code secs. 871(a) and 881) if received by a nonresident alien individual or a foreign corporation.

Interest is not entitled to the exemption from U.S. tax if it is effectively connected with the conduct by the foreign recipient of a trade or business within the United States and thus is taxed at the regular graduated rates. Also, interest is not exempt if it is paid to a foreign person having a direct ownership interest in the U.S. payor. In the case of payments from domestic corporations, direct ownership exists if the recipient of the interest owns or is considered as owning 10 percent or more of the total combined voting power of all classes of stock entitled to vote of that corporation. In the case of interest paid by a domestic partnership, direct ownership exists if the recipient of the interest owns or is considered as owning 10 percent or more of the capital or profits interest of the partnership.

To prevent U.S. persons from indirectly taking advantage of this exemption, the bills provide that a foreign corporation which is a controlled foreign corporation (within the meaning of sec. 957) is not

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[1] Section 201 of the bill as reported; S. Rept. No. 96–504.

to be entitled to the exemption for interest received from U.S. persons.

Although the bills provide an exemption for payments of interest to foreign persons, the Finance Committee stated in its report on H.R. 2297 that it does not intend to waive the information reporting requirements which would be applicable under present law to these exempt amounts. The committee further stated that it expects that regulations will be prescribed under these provisions so that the Secretary can report back to the committee the foreign persons (and their country of residence) who are receiving the benefits of this exemption.

In cases where the payor does not know the identity of the beneficial owner of the securities with respect to which the interest or original issue discount is paid, the Secretary of the Treasury may, under present law (Code sec. 1441(c)(2)), prescribe by regulations circumstances in which the payor, or any person having custody or control of the payment, will be required to withhold amounts as tax due. The present regulations require withholding where the ultimate recipient of the interest is unknown. The Finance Committee stated that it contemplates that the Secretary will exercise this authority with respect to payments of original issue discount and interest to the extent necessary to ensure that the collection of the tax imposed upon payments of interest and original issue discount to foreign persons owning a 10-percent or greater interest in the U.S. payor and to controlled foreign corporations.

Estate tax

In the case of nonresident alien individuals, the bills also eliminate any potential U.S. estate tax liability in the case of obligations the income from which, if received by the decedent at the time of his death, would be exempt from tax.

Prevention of tax evasion

The bills provide that if the Secretary of the Treasury determines that the United States is not receiving sufficient information from a foreign country to identify the true beneficial recipients of the interest payments and if the Secretary believes such information is necessary in order to prevent evasion of taxes, the exemption will no longer apply to payments addressed to or for the account of persons within that country for future issuances of debt obligations. The termination is to continue until the Secretary determines that the exchange of information between the United States and that country is sufficient to identify the beneficial recipients of the interest. Any termination of the exemption for interest will also automatically terminate the exemption from the estate tax on the debt obligations.

Effective date

The amendments providing for the income tax exemption would apply to interest paid after the date of enactment. The amendments providing for an estate tax exclusion for debt obligations would apply to estates of decedents dying after the date of enactment.

Revenue effect

It is estimated that this provision will reduce budget receipts by $36 million in fiscal year 1981, $39 million in 1982, $43 million in 1983, $47 million in 1984, and $52 million in 1985.

V. ISSUES

In General

Capital formation and balance of payments.—Proponents of the repeal of withholding on interest argue that it would result in a considerable infusion of foreign capital into the United States, helping our balance of payments situation, strengthening the dollar, assisting in capital formation, and helping to create jobs. Repeal would permit investment in longer-term debt than the 6-month exemption for original issue discount permitted under present law. Moreover, this capital would be in the form of debt, rather than equity, and thus would not increase the extent to which U.S. businesses are controlled by foreign investors. Opponents argue that repeal is unlikely to result in any significant net increase in foreign investments in the United States but rather will result in the substitution of these obligations for other existing investments. In their view, net increases of foreign investments in the United States will depend on more fundamental factors than the repeal of a tax which can fairly easily be avoided. They also point out that, ultimately, the debt will have to be repaid, with interest, resulting in an even greater outflow of capital than was originally infused. Proponents respond by stating that, in the meantime, U.S. businesses would have enjoyed the use of the funds, on which they would presumably have earned more in income than they were required to pay out, and that once foreign funds are attracted to the U.S. debt market, there is an excellent chance that they will remain invested here indefinitely in one form or another. However, opponents respond more generally to the argument that repeal will make capital more available by pointing out that this result would apparently be directly contrary to recent steps taken to restrain the availability of credit in order to reduce inflation.

Revenue impacts.—Those in favor of repeal of the withholding tax on interest argue that there are already so many exceptions to the withholding tax that there is little point in retaining the tax in the few situations to which it does apply. In 1977, for example, only $24,432,000 was collected on $515,418,000 of portfolio interest paid to foreign taxpayers; an effective rate of 4.7 percent. Proponents of repeal argue that the repeal of withholding in the few remaining cases where it is applicable will relieve taxpayers from complying with considerable administrative burdens where the tax is not applicable and would be an important simplification. Opponents of repeal argue on the other hand that the revenue raised by the tax (an estimated $36 million in fiscal year 1981), while small in percentage terms, is nevertheless significant.

Equity arguments.—Opponents of repeal argue that it would be inequitable to exempt foreign lenders from tax on U.S. source interest income while continuing to tax interest received by U.S. lenders. In their view, foreign lenders enjoy the income and security from investing in the United States and thus should not be exempt from paying U.S. tax on the income received, particularly since the U.S. borrowers reduce their U.S. tax by deducting the interest payments. They argue that the repeal of the tax on foreign lenders at the same time as the Administration is proposing the imposition of withholding on interest and dividends paid to U.S. taxpayers would be viewed by those U.S. taxpayers as especialy unfair.

Proponents of repeal counter that the correct comparison is not with the U.S. treatment of U.S. lenders but with the way in which other foreign countries treat lenders from outside their borders (e.g., Australia, Denmark, France, Finland, Japan, the Netherlands, Norway, and Sweden, which at least in the case of bonds issued in foreign currencies, do not impose withholding taxes), since these rules determine the environment in which U.S. borrowers must compete for funds. Proponents point out that many other countries provide mechanisms for the issuance of Eurobonds free of withholding tax. Proponents claim that the equity argument is superficial because, in their view, foreign lenders will not pay U.S. tax on U.S. source interest income even if the United States continues to impose it; they will instead merely invest elsewhere.

Proponents also argue that the U.S. rule that interest paid by a U.S. person is from U.S. sources is in many instances arbitrary and that jurisdiction to tax movable capital might as easily be based on the residence of the lender. Opponents counter that such a rule would imply that no foreign tax credit should be allowed U.S. lenders on interest they receive from foreign borrowers, a result which would be strongly opposed by U.S. lenders.

Tax avoidance and evasion.—Opponents argue that if no withholding tax is imposed on interest by the country of the borrower, it would greatly increase the flow of movable capital to tax havens and bank secrecy jurisdictions, with the result that no tax would be paid on the interest to any country. In addition, because of the difficulties of enforcement, at least some of these tax-free bonds would probably be held by U.S. persons evading U.S. tax. They (opponents of repeal) argue that withholding at source is the only effective way to prevent tax avoidance and evasion. In this regard, they note that several of our major tax treaty partners have objected to the proposed repeal of the U.S. withholding tax. It is argued that repeal of withholding would undercut the long-term efforts of the United States to curb international tax evasion and avoidance, and to encourage other countries to assist in that effort. Those favoring repeal argue in response that there presently are virtually unlimited opportunities for taxpayers to evade taxes if they intend to do so and that repeal of the U.S. withholding tax on U.S. corporate bonds is unlikely to cause anyone to evade or avoid taxes who would not do so in any event. Moreover, they see as hypocritical the ojections of our treaty partners because in many situtions these countries permit their borrowers to pay interest to foreign lenders without withholding taxes.

Treaty negotiations.—Opponents also argue that repeal of the withholding tax would result in the surrender of a valuable "bargaining chip" available to our tax treaty negotiators. That is, if investors of a foreign country would be subject to a 30-percent tax unless their country entered into a tax treaty with the United States, then their government would have a greater incentive to enter into a tax treaty to eliminate the tax. The United States could insist on a reciprocal concession as the price of such a provision. In that regard, opponents of repeal note that 37.6 percent of the revenue (as shown in the table) is from Canada, which recently has refused in the pending treaty negotiations to agree to a reciprocal reduction of withholding rates on interest below 15 percent. Moreover, an additional 31.4 percent of the revenue is from Switzerland, France, and Japan which also have refused to reciprocally reduce withholding rates on interest to zero. Thus, more than two-thirds of the revenue loss resulting from unilateral repeal would merely be a windfall for investors from these four countries.

On the other hand, however, those favoring repeal argue that reliance on reciprocal rate reductions or exemptions in tax treaties is arbitrarily discriminatory in the area of portfolio investment. Proponents of repeal further argue that, even if the withholding tax were repealed, other countries would still have an incentive to enter into treaties with the United States to reduce double taxation of income other than interest and to eliminate fiscal evasion. This is particularly true if, as in the case of the bills, the repeal is targeted so that it does not apply to interest paid to related parties. In addition, many foreign countries might prefer not to encourage their investors to export capital to the United States.

Treaty shopping.—Proponents of the repeal of the tax argue that present law has a much more deleterious effect on the tax treaty program than the loss of any possible advantages that the tax may have as a bargaining chip. In order to attract needed foreign investment, they argue, the United States must permit U.S. corporations to issue tax-free Eurobonds through finance susidiaries in the Netherlands Antilles. This approval of the use of treaties by third-country nationals encourages other "treaty shopping" abuses of our tax treaty network.

Moreover, the use of finance subsidiaries to accomplish essentially the same result as repeal of the withholding tax is unnecessarily complex and expensive to the corporation issuing the bonds. Their use is expensive to the U.S. Treasury since the taxes paid to the Antilles by the finance subsidiaries are claimed by their U.S. parents as foreign tax credits.

Opponents respond that the treaty shopping abuses of the Netherlands Antilles and other treaties can be eliminated by simply revising the treaties—that if the problem is the avoidance of U.S. tax through abuses of U.S. tax treaties, repeal of the tax would not be a sensible solution to the tax avoidance.

Foreign tax credit.—Opponents of repeal also point out that if the foreign investor is from a high-tax country, he generally will be allowed a foreign tax credit for the withholding taxes paid to the United States and therefore the repeal of withholding will not provide any greater return to him which would give him a greater incentive to invest in the United States. Instead there would only be a transfer from the U.S. Treasury to his foreign country's treasury.

On the other hand, proponents of repeal point out that if the investor is from a low-tax country, repeal of withholding generally would make a difference to him. Also, there are significant accumulations of wealth held by pension trusts in developed countries which may be entirely exempt from foreign tax. In addition, if a foreign financial institution is subject to the 30-percent U.S. withholding tax on gross income rather than the regular net income tax because it leads into the United States from a foreign office, the U.S. tax will probably exceed its foreign tax on the income. In both of these cases, repeal of U.S. withholding would also provide a positive incentive to invest in the United States (although, as opponents argue, there is no reason the elimination of U.S. tax cannot be targeted to these limited classes of foreign persons through a narrow Code amendment or through a reciprocal treaty exemption). Also, depending on the mechanism his foreign country has adopted for estimated tax payments, he may lose the use of the amount withheld for the period between the time the U.S. tax is withheld on the interest and the time he can secure a credit from his government.

Foreign banks.—Under present law and Treasury regulations, foreign banks are subject to the regular U.S. corporate income tax if they book the loans through U.S. branch offices, but if they book loans to U.S. borrowers through a foreign branch, they are subject to the 30-percent U.S. gross withholding tax (unless a treaty rate reduction or exemption applies). Repeal of the withholding tax would make it possible for foreign banks to lend to U.S. borrowers from nontreaty tax haven countries without payment of either the regular corporate tax or the withholding tax. This tax exemption, together with their exemption from reporting requirements and reserve requirements applicable to U.S. banks and recently extended to U.S. branches of foreign banks, would provide to these foreign banks operating from offshore a competitive advantage over U.S. banks and U.S. branches of foreign banks and, in addition, would reduce the Federal Reserve's control over the banking system. Proponents of repeal question whether, as the result of repeal, foreign banks would begin booking their U.S. loans from offshore to any significant extent. They point out, for instance, that in many cases foreign banks at present can lend into the United States from many treaty countries without any U.S. tax, yet there does not appear to be any significant activity in this regard. They argue, moreover, that offshore booking, if it were to occur, would not so much be caused by the repeal of the withholding tax but rather by the rules treating interest income derived by banks and other financial institutions as not effectively connected with a U.S. trade or business as long as it is booked through a foreign branch, and they maintain that this is an unrelated problem which can be separately resolved, if deemed appropriate, by amending the Code or the regulations.

The U.S. withholding tax as a protective tariff.—Those favoring repeal argue that the U.S. withholding tax on interest paid to foreigners in effect operates as a protective tariff. Its principal impact is to prevent foreign investors from buying U.S. corporate bonds, and therefore they do not pay the tax. As a protective tariff, it simply keeps foreign private capital out of our bond markets and does not raise significant revenue. Opponents of repeal contest the characterization of the tax as a protective tariff. In their view, a protective tariff is a levy imposed on the importation of goods or services which would not be imposed if the goods or services were produced locally.

The withholding tax imposed on foreign lenders, in contrast, is comparable to, and in lieu of, the income tax imposed on U.S. lenders, and it is not designed to discourage foreign persons from buying U.S. corporate bonds but merely to subject them to a tax comparable to the tax paid by U.S. bondholders. The fact that the tax is not analogous to a protective tariff, it is argued, can be demonstrated by the fact that the U.S. tax does not result in any net increase in the foreign bondholder's aggregate worldwide tax burden, and thus does not discourage investors from buying U.S. corporate bonds, as long as the bondholder is willing to report the U.S. interest for tax purposes in his home countries and claim a credit for the U.S. tax.

Foreign policy aspects.—As previously noted, one of the principal methods for the avoidance of U.S. withholding taxes on corporate obligations is the use of Netherlands Antilles finance subsidiaries. This results in considerable financial activity in the Antilles. The Antilles government has argued against repeal of the general withholding requirement in the Code on the ground that it would no longer be necessary to route borrowings through the Antilles, and the use of the Antilles as a financial center would be substantially reduced. The Antilles government has estimated that the offshore financing activities generate between $40 million and $44 million in revenues, amounting to 25 to 30 percent of the Antilles federal budget. To insure the stability of the Antilles, the United States might find it necessary to replace a considerable part of these revenues with foreign aid.

Proponents of repeal point out, however, that the need to route transactions through the Antilles adds needlessly to the cost of borrowing. The same business that now generates jobs in the Antilles could be used to generate more financial jobs in the United States. Because of the availability of the foreign tax credit, some of the revenues collected by the Antilles may in effect already come out of the U.S. Treasury through reduction of the U.S. tax burden on the U.S. parent of an Antilles finance subsidiary. Further, proponents of repeal argue that it is illogical from a foreign policy standpoint for the U.S. contribution to a Caribbean country's economy to be determined by that year's volume of Eurobond offerings.

Disclosure requirements

The Senate Finance Committee report makes it clear that the committee intends that the information reporting requirements of present law remain in effect with respect to interest exempt from withholding tax. In addition, the report points out that, under present law, the Treasury is authorized to require withholding where the payor of the income does not know the owner of the securities on which the interest is paid. The committee report states that this authority is to be used to ensure the collection of tax where interest is paid to direct investors or CFCs.

Those who oppose the interest reporting requirement contend that it does not comport with the realities of the Eurobond marketplace and therefore would nullify any beneficial effect of the repeal of withholding. They point out that the Eurobonds issued by competing borrowers from other countries do not require withholding, are free of reporting requirements, and are typically in bearer, rather than registered, form.

A requirement that the lender report his identity to qualify for exemption from withholding would impose an administrative burden on lenders and could also raise some doubt in the minds of the lenders as to whether the obligations in their hands qualified for exemption from withholding. Those arguing that the disclosure requirements should be deleted from the bill argue that the loss of anonymity would make it impossible, as a practical matter, to market the obligations of U.S. borrowers to those foreign investors who are unwilling to have their identities disclosed to the IRS.

Those who support the information reporting requirements argue that, without these rules, it would be simple for direct investors and foreign subsidiaries to avoid the limitations on the exemption from withholding. It would be possible, although difficult, to track down interest income paid to foreign subsidiaries through the Internal Revenue Service audit process. Many U.S. shareholders of CFCs would never be audited. It would generally not be possible to audit foreign direct investors. Additionally, those supporting reporting requirements argue that their absence would assist U.S. persons to evade U.S. tax by investing anonymously in bearer obligations abroad. They argue further that the principal reason foreign holders of bearer bonds would refuse to disclose their identities to the IRS is that they are evading taxes and currency control requirements of their own countries. They argue further that a decision by the United States not to require the reporting of the identity of the beneficial owner in order to increase the marketability of bonds issued by U.S. companies would be contrary to the U.S. policy not to condone foreign fiscal fraud (as expressed, for example, in the Code rules added by the Tax Reform Act of 1976 denying foreign tax benefits when foreign officials are bribed) and contrary to the spirit of our tax treaty exchange of information obligations.

Foreign subsidiaries (Controlled Foreign Corporations)

The bills do not provide an exemption for interest paid to controlled foreign corporations (CFCs)[1] on the grounds that there are a number of ways in which such an exemption could result in undue tax advantages. If CFCs could receive interest income free of withholding tax, U.S. tax on that income could be deferred indefinitely if the CFC also had an active business. Alternatively, if the U.S. parent had excess foreign tax credits from unrelated foreign business operations, the interest could in effect be repatriated to the parent tax-free. Finally, even if neither of these fact patterns applies and the interest income of the foreign subsdiary is currently taxable to the U.S. parent under subpart F without being fully offset by foreign tax credits, the U.S. parent could benefit by being able to invest pre-tax dollars in U.S. debt obligations rather than only the amount remaining after imposition of U.S. tax. Each of these possibilities is explained in greater detail below.

In the case of a controlled foreign corporation (CFC), subpart F (secs. 951–64 of the Code) provides that, in general, the United States shareholders must currently include in their income certain types of

[1] Generally, a foreign corporation is a CFC if more than 50 percent of the voting power is held by "United States shareholders," that is, U.S. persons each of whom holds 10 percent or more of the voting power.

tax haven income of the corporation and certain types of passive investment income, including interest income. However, no inclusion is required if these types of income amount to less than 10 percent of the gross income of the corporation. Most corporations with active businesses abroad are eligible for this exception because the *gross* income from their business activity is generally more than 90 percent of total gross income even though their net investment income may be a larger proportion of their overall net income because of greater expenses associated with the active conduct of a business.

Advantages could exist for the U.S. shareholder of a CFC even if the shareholder were required to report the interest income currently. For example, suppose that a U.S. parent company has excess foreign tax credits.[2] If the U.S. parent company lent money directly to a U.S. borrower, the U.S. parent would, of course, be taxable on the interest income. However, if the U.S. parent makes the loan through a foreign subsidiary (a CFC), the U.S. parent may, in effect, receive the income tax-free. The U.S. source interest income could (in the absence of U.S. withholding) be received by the subsidiary free of U.S. tax. The only tax paid by the subsidiary would be the tax imposed by the country in which it is received, which may be considerably lower than the U.S. tax rate paid by the parent.[3] When this interest income of the subsidiary is taxed to the U.S. shareholder under subpart F as an actual or constructive dividend, the dividend may be treated as foreign source income, because the CFC is a foreign corporation, even though the interest income received by the CFC was from U.S. sources. Thus, U.S. source income (the interest) may in effect be converted into foreign source income (the dividend). This increases the U.S. shareholder's foreign tax credit limitation and may permit the taxpayer to use its excess foreign tax credits from its unrelated foreign active business operations (which might otherwise expire unused) to offset completely its U.S. tax on the income, allowing the U.S. interest income to be received without imposition of any U.S. tax.

A U.S. shareholder of the CFC may obtain tax advantages from repeal of the withholding tax even if the shareholder is not in an excess foreign tax credit position. If the CFC has accumulated earnings

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[2] The United States taxes domestic taxpayers on their worldwide income, but allows a credit against its tax for foreign income taxes. The credit allowable in any year is limited, however, by a formula which is generally intended to allow the foreign tax credit to be used only to offset the U.S. tax paid on the taxpayer's foreign source income, not the tax on its U.S. source income. Generally, the limitation is equal to the taxpayer's pre-credit U.S. tax multiplied by a fraction, the numerator of which is the taxpayer's foreign source taxable income and the denominator of which is the taxpayer's worldwide taxable income. A taxpayer whose foreign income taxes are greater than this limit is said to have excess tax credits. The excess credits may be carried back 2 years and forward 5 years to be utilized in years in which the taxpayer's foreign tax credit limitation formula exceeds foreign income taxes actually paid. However, if the excess credits cannot be used in any of these years, they are lost forever. Many taxpayers find that, because of high foreign tax rates, they are chronically in an excess credit position.

[3] If the tax paid on the interest to the foreign country in which it is received is at least equal to the U.S. rate of tax, then the parent would have no incentive based on this analysis to structure the loan through the foreign subsidiary. However, if it did so, the parent would still pay no U.S. tax, so the net result would be a transfer of funds from the U.S. Treasury to the foreign country's treasury.

abroad which are not subpart F income, it could not repatriate them without paying U.S. tax on the dividend income.[4] The U.S. shareholder could then reinvest only the after-tax acount of the dividend in obligations of U.S. companies. However, if the income is not repatriated, the CFC could invest the pre-tax amount of earnings (which, if foreign income taxes are low, could be considerably larger than the amount which would remain after U.S. tax) in obligations of U.S. companies. Thus, although the U.S. parent would be subject to current U.S. tax on the interest income earned by the foreign subsidiary under subpart F (unless the 10-percent *de minimis* rule described earlier applied), the subsidiary would have had a larger amount available to invest, and thus would receive more income, than the U.S. parent would have had if the funds had been repatriated to it as a dividend. This could be attractive if the subsidiary were not also burdened with a withholding tax on interest received. While this would be attractive even where the higher amounts of interest income of the CFC are currently taxable to the U.S. parent under subpart F, it is particularly attractive where, on account of the 10-percent *de minimis* rule, the interest is not subpart F income taxable to the U.S. parent.

Those who favor extending the repeal of the withholding tax to interest paid to CFCs point out in this last situation that discouraging the CFC from investing in debt of U.S. obligors is contrary to the policy expressed by Congress in the Tax Reform Act of 1976. Prior to the amendments made by that Act, U.S. shareholders of CFCs were treated as receiving a dividend from the CFC whenever the CFC invested in "U.S. property," including debt obligations of U.S. persons. This rule was adopted because it was felt that reinvestment of the funds in the U.S. was a repatriation essentially equivalent to a dividend. However, the 1976 Act changed this rule to permit portfolio investments in the United States without imposition of current tax under subpart F. Thus, CFCs were no longer encouraged by subpart F to reinvest earnings abroad, rather than in the United States. It was believed that this would improve the U.S. balance of payments by encouraging capital inflow from CFCs into the United States. Proponents also point out that, if a U.S. withholding tax is imposed on interest received by a CFC, and the U.S. tax on dividends from the CFC is not eliminated by the foreign tax credit, double taxation of the income will result. That is, the income will be taxed once by the U.S. when paid to the CFC and will be taxed a second time when paid as a dividend by the CFC to the U.S. shareholder.

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[4] This assumes that the U.S. shareholder would not be entitled to an indirect foreign tax credit (for taxes paid by the CFC on its income) which would eliminate U.S. tax on the dividend.

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