[JOINT COMMITTEE PRINT]

# BACKGROUND AND ISSUES RELATING TO THE TAXATION OF FOREIGN INVESTMENT IN THE UNITED STATES

Scheduled for Hearings

before the

## HOUSE COMMITTEE ON WAYS AND MEANS

ON JANUARY 24-25 AND 30-31, 1990

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Prepared by the Staff

of the

## JOINT COMMITTEE ON TAXATION

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## INTRODUCTION

The House Committee on Ways and Means has scheduled public hearings on January 24-25 and 30-31, 1990, on foreign investment in the United States, "Europe 1992," and trade relationships with the Soviet Union and Eastern Europe. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides background information and discusses issues relating to the taxation of foreign investment in the United States.

Part I provides background information on foreign investment in the United States. Part II is a description of present-law tax rules, and Part III discusses issues related to the taxation of foreign investment in the United States.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

# I. BACKGROUND

## A. International Investment Position of the United States

### *Trends in international investment*

The amount of foreign-owned assets in the United States grew more than 700 percent between 1975 and 1988 and more than three-fold since 1980.[2] The total amount of foreign-owned assets in the United States exceeded $1.7 trillion by the end of 1988. The recorded value of U.S.-owned assets abroad grew less rapidly during the same period. The Department of Commerce reports that in 1975 the amount of U.S.-owned assets abroad exceeded foreign-owned assets in the United States by $74 billion. By the end of 1988, however, the situation had reversed, so that the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad by $532 billion.

**Table 1.—International Investment Position of the United States at Year-end 1975–1988**

[Billions of dollars]

| Year | U.S.-owned assets abroad | Foreign-owned assets in the U.S. | Net international investment position of the U.S. | Foreign direct investment in the U.S. |
|---|---|---|---|---|
| 1975 | $295.1 | $220.9 | $74.2 | $27.7 |
| 1976 | 347.2 | 263.6 | 83.6 | 30.8 |
| 1977 | 379.1 | 306.4 | 72.7 | 34.6 |
| 1978 | 447.8 | 371.7 | 76.1 | 42.5 |
| 1979 | 510.6 | 416.1 | 94.5 | 54.5 |
| 1980 | 607.1 | 500.8 | 106.3 | 83.0 |
| 1981 | 719.6 | 578.7 | 140.9 | 108.7 |
| 1982 | 824.8 | 688.1 | 136.7 | 124.7 |
| 1983 | 873.5 | 784.5 | 89.0 | 137.1 |
| 1984 | 895.9 | 892.6 | 3.3 | 164.6 |
| 1985 | 949.7 | 1,061.1 | −111.4 | 184.6 |
| 1986 | 1,073.3 | 1,341.1 | −267.8 | 220.4 |
| 1987 | 1,169.7 | 1,548.0 | −378.3 | 271.8 |
| 1988 | 1,253.7 | 1,786.2 | −532.5 | 328.9 |

Source: Russell Scholl, "The International Investment Position of the United States in 1988." *Survey of Current Business,* U.S. Department of Commerce, Bureau of Economic Analysis, June, 1989, p. 43.

[2] All values in this paragraph are reported in Table 1 and are obtained from Russell Scholl, "The International Investment Position of the United States in 1988," *Survey of Current Business,* U.S. Department of Commerce, Bureau of Economic Analysis, June 1989, p. 43.

*Types of foreign investment*

A more detailed breakdown of the international investment position of the United States for 1988 is presented in Table 2. The international investment position is analogous to a balance sheet of the United States with respect to the rest of the world. The top part of the table presents the amount of U.S. assets held by foreigners, which represent the financial claims of the rest of the world on the United States; the next portion of the table presents the assets of the United States abroad; and the bottom line in the table nets the amount of U.S. assets abroad against the amounts of assets of foreign entities in the United States.

**Table 2.—International Investment Position of the United States at Year-end, Selected Years, 1975–1988**

[Billions of dollars]

| | 1975 | 1980 | 1985 | 1988 |
|---|---|---|---|---|
| ***Foreign Assets in the United States*** | **$220.9** | **$500.8** | **$1,061.1** | **$1,786.2** |
| Direct investment | 27.7 | 83.0 | 184.6 | 328.9 |
| Private, non-direct investment | 106.3 | 241.7 | 673.7 | 1,135.3 |
| Treasury securities | 4.2 | 16.1 | 83.6 | 96.6 |
| Stocks | 35.6 | 64.6 | 123.7 | 198.4 |
| Bonds | 10.0 | 9.5 | 82.5 | 195.2 |
| Other debts, bank and non-bank | 56.4 | 151.5 | 384.0 | 645.0 |
| Official investment | 86.9 | 176.1 | 202.7 | 322.1 |
| ***U.S. Assets Abroad*** | **295.1** | **607.1** | **949.7** | **1,253.7** |
| Direct investment | 124.1 | 215.4 | 230.3 | 326.9 |
| Private, non-direct investment | 113.0 | 301.2 | 588.6 | 793.5 |
| Government assets | 58.0 | 90.5 | 130.8 | 133.3 |
| ***Net International Investment Position of the United States*** | **74.2** | **106.3** | **−111.4** | **−532.5** |

Source: Russell Scholl, "The International Investment Position of the United States in 1988." *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, June, 1989, p. 43.

Foreign assets in the United States (and U.S. assets abroad) can be categorized as direct investment, non-direct investment (often referred to as portfolio investment), and official assets.

"Direct investment" constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, 10 percent of the voting securities of a corporate enterprise or the equivalent interests in an unincorporated business.[3] This arbitrary definition may only approximately reflect situations in which control is exercised. For example, a group of investors may act jointly without any single person having 10-percent ownership. Likewise, in some cases a 10-percent owner may have little or no direct control over the disposition of the assets in which an interest is held.

The second, and largest, category of investment is non-direct investment held by private (non-governmental) foreign investors, commonly referred to as portfolio investment. This category consists mostly of holdings of corporate equities, corporate and government bonds, and bank deposits. The portfolio investor generally does not have control over the assets that underlie the financial claims. In 1988, portfolio assets of foreign persons in the United States were more than triple the recorded value of direct investment, $1,135 billion compared to $329 billion, respectively. Bank deposits account for well over half of this total, and reflect partially the increasingly global nature of banking activities. Foreign investment in bonds and bank deposits, like other types of financial investment, provide a source of funds for investment in the United States but also represent a claim on future resources.

The final category of foreign-owned U.S. assets is official assets: U.S. assets held by governments, central banking systems, and certain international organizations. The foreign currency reserves of other governments and banking systems, for example, are treated as official assets. Levels of foreign-held official assets have grown more slowly than foreign-held direct and non-direct investment of private investors.

The difference between the value of U.S.-held assets abroad and the value of foreign-held assets in the United States is the net international investment position of the United States. This number is often looked at in determining whether the United States is a "net debtor" or "net creditor" to the rest of the world. A net debtor nation is one for which foreign investors have more claims on domestic assets that domestic investors have abroad; a net creditor is in the opposite situation. The use of the term "creditor" or "debtor" in this context has nothing to do with the legal form of the claims, but rather the balance of cross-border ownership with the rest of the world.

Based on the Department of Commerce statistics presented in Table 1, the United States became a net debtor nation in 1985 and by the end of 1988 the difference exceeded $500 billion. Due to a variety of measurement problems, however, the actual debtor or creditor status and level of the United States may be substantially different than the level calculated.[4] While the exact debtor or cred-

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[3] The definition is arbitrary and used for data organization. Ownership of 11 percent of a corporation's stock is a direct investment; ownership of 9 percent is not. The definitions of direct and portfolio investment for tax purposes are different.

[4] U.S. Department of Commerce, Bureau of Economic Analysis, "Measuring the U.S. International Investment Position," *Survey of Current Business*, June, 1989, p. 40. See also, Michael Ulan and William Dewald, "The U.S. Net International Investment Position: Misstated and Misunderstood," in James Doran and William Niskanen, eds. *Dollars, Deficit, and Trade*, 1989. The misvaluation problem is particularly acute for direct investment. It is widely believed that the value of U.S. direct investment abroad is substantially understated, more so than foreign direct investment in the United States.

itor status may be questioned, the conclusion that foreign-owned assets in the United States are growing much faster than U.S.-held assets abroad is likely to be unaffected by any measurement issues.

## B. Balance of Payments and Foreign Investment

### *Balance of payments*

While the rapid growth of both foreign-held assets in the United States and U.S.-held assets abroad is symptomatic of the increasing integration of the global economy, the change in the net international position of the United States discussed above is directly related to the change in the U.S. trade balance in the 1980s. As has been widely reported, the merchandise trade deficit, which is defined as U.S. merchandise imports in excess of merchandise exports, has been over $100 billion per year since 1984. The current account as a whole, which compares exports of both goods and services to imports (plus unilateral remittances) was positive as late as 1981, but has been in deficit by over $100 billion per year since 1984 as well.

**Table 3.—International Transactions of the United States, Selected Years, 1980–1988**

[Billions of dollars]

| | Average 1980–85 | 1986 | 1987 | 1988 |
|---|---|---|---|---|
| **Current Account Balance=** | **−$43.1** | **−$133.2** | **−$143.7** | **−$126.5** |
| +*Exports of Goods and Services* | 358.8 | 392.0 | 446.1 | 529.8 |
| Merchandise | 218.4 | 223.4 | 250.3 | 319.3 |
| Services | 58.1 | 80.0 | 91.2 | 102.8 |
| Receipts from U.S. assets abroad | 82.4 | 88.6 | 104.7 | 107.8 |
| −*Imports of Goods and Services* | 391.6 | 509.4 | 575.6 | 641.7 |
| Merchandise | 283.6 | 368.4 | 409.8 | 446.5 |
| Services | 52.6 | 74.0 | 83.4 | 89.7 |
| Payments on foreign-owned U.S. assets | 55.3 | 67.0 | 82.4 | 105.5 |
| −*Unilateral Transfers* | 10.3 | 15.8 | 14.2 | 14.7 |
| **Capital Account Balance=** | **22.0** | **121.9** | **141.8** | **137.2** |
| +*Foreign Investment in the U.S.* | 92.1 | 221.6 | 218.0 | 219.3 |
| Direct investment | 18.7 | 34.1 | 46.9 | 58.4 |
| Private, non-direct investment | 68.0 | 151.9 | 126.1 | 122.0 |
| Official | 5.3 | 35.6 | 45.2 | 38.9 |
| −*U.S. Investment Abroad* | 70.5 | 99.7 | 76.2 | 82.1 |
| Direct Investment | 8.0 | 26.3 | 44.2 | 17.5 |
| Private, non-direct investment | 53.2 | 71.6 | 42.2 | 64.0 |
| Increase in Government assets | 9.4 | 1.7 | −10.1 | 0.6 |
| +*Allocation of Special Drawing Rights* | 0.4 | 0.0 | 0.0 | 0.0 |
| *Statistical Discrepancy* | 21.1 | 11.3 | 1.9 | −10.6 |
| **Note: Trade Balance** | **−65.3** | **−145.1** | **−159.5** | **−127.2** |

Source: Russell Krieger, "U.S. International Transactions, First Quarter, 1989." *Survey of Current Business,* U.S. Department of Commerce, Bureau of Economic Analysis, June, 1989, pp. 62-63.

The balance of payments accounts, presented in Table 3, are analogous to a sources and uses of funds statement of the United States with the rest of the world. By definition, the current account balance, which consists primarily of the trade balance, should be exactly offset by the capital account balance, which measures the net inflow or outflow of capital to or from the United States. Serious problems of measurement cause the accounts to be somewhat mismatched in practice, but basic patterns are unlikely to be significantly distorted by these problems. Thus, the recent net inflows of capital into the United States may be viewed as a reflection of the trade deficits.

*Net returns on existing assets*

One aspect of the balance of payments figures presented in Table 3 leads some observers to argue that the negative net investment position presented in Tables 1 and 2 is overstated. The receipts from U.S.-owned assets abroad in 1988 were 107.8 billion while the payments on foreign-owned assets in the United States were $105.5 billion. Since these figures represent the return on the capital invested abroad and in the United States, respectively, some argue that the market value of U.S.-owned assets abroad is similar to or greater than the value of foreign-owned assets in the United States, if they were measured accurately. Whether this argument is true or not regarding the current net investment position, it is clear that the payments on foreign-owned U.S. assets are growing much faster than, and will likely soon exceed, the receipts from U.S.-held assets abroad.

## C. Foreign Direct Investment in the United States

*General trends*

Much of the public attention directed to foreign investment in the United States has focused on the direct investment component, often because of concern over control exercised by foreign persons. As mentioned above, direct investment represents assets over which the foreign investor likely has some level of control.

The measurement of foreign direct investment is performed in two different ways. The first method, known as the balance of payments method, measures direct investment by reference to the amount foreign investors invest in U.S. businesses through the purchase of stock, lending of money, or reinvestment of earnings. This is the method used for purpose of the balance of payments accounts and is presented in the tables. This measure represents the *financial investment* of foreign *investors* in the United States.

The second method measures the amount of *assets* that are under the *control* of foreign investors. This method may be more useful in considering the economic impact that foreign control of assets may have on the United States. For example, under this method, if a foreign acquirer pays $100 for a company with $200 of assets (and $100 of liabilities), this measure would report $200 of direct investment assets. Under the balance of payments method, the direct investment is $100.

U.S. affiliates of foreign companies or investors accounted for 13.2 percent of all U.S. manufacturing assets and 7.3 percent of

U.S. manufacturing employment in 1987.[5] Foreign direct investment is concentrated in manufacturing, so that overall 3.6 percent of U.S. employees (3.159 million) worked for U.S. affiliates of foreign companies in 1987. Obviously, these figures represent averages, and the concentration of foreign ownership may be higher or lower in specific industries.

The role of foreign direct investment is more significant in banking than in most other sectors of the economy. In 1988, U.S. affiliates of foreign banks held over $600 billion in assets, or 19.2 percent of the total for all banks.[6] The foreign percentage is slightly lower for loans and deposits at 16.6 and 13.4 percent, respectively.

A subject of some attention is the amount of foreign ownership of U.S. real estate. In 1987, just over $90 billion of U.S. commercial property was owned by U.S. affiliates of foreign companies.[7] The distribution of these holdings are concentrated geographically so that 45 percent of the value is located in the three states of California, New York, and Texas. In terms of land, U.S. affiliates reportedly owned 13.8 million acres (less than 1 percent of the total acreage in the United States) in 1987.

The most common method for foreign investors to establish a new direct investment in the United States is through the acquisition of an existing business enterprise. In 1988, foreign investors made outlays for acquisitions of existing businesses of $60 billion, while outlays for the establishment of new business enterprises were just $5 billion.[8] Some additional direct investment is performed through the reinvestment of earnings in existing businesses and new capital provided to existing businesses. Of course, net investment depends on sales of foreign owned businesses and repatriation to foreign owners of capital invested in the United States as well.

### *Ownership by country*

The stock of foreign direct investment in the United States, as measured by the balance of payments method, totalled $328 billion at the end of 1988. Table 4 presents the distribution by country of ownership. Nearly two-thirds of the total direct investment in the United States was attributable to European countries, 59 percent to countries in the European Community. The United Kingdom was the country with the largest ownership with over $100 billion of investment. Japan, the second largest source of foreign direct in-

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[5] All data in this paragraph is from Ned Howenstine, "U.S. Affiliates of Foreign Companies: 1987 Benchmark Survey Results," *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, July, 1989, pp. 116-142. Manufacturing, for purposes of this analysis, includes petroleum and coal products. All figures consistently exclude banking activities. Due to definitional issues, a very small percentage of assets and employment attributed to foreign companies have a U.S. person as the ultimate beneficial owner. The term affiliate is used throughout this section in the generic sense to refer to any U.S. business enterprise that meets the definition for direct investment, regardless of the legal form of the enterprise.

[6] Edward Graham and Paul Krugman, *Foreign Direct Investment in the United States*, 1989, p. 21. The figures are obtained from the Federal Reserve Board and are from June of 1988.

[7] Commercial property is defined as the gross book value of commercial buildings and the associated land. Howenstine, 1989, p. 124. Certain investment channels are not captured by the data collection process. This exclusion is not believed to cause a dramatic understatement of the amount of real estate in foreign hands. Graham and Krugman, 1989, pp. 21-24.

[8] Ellen Herr, "U.S. Business Enterprises Acquired or Established by Foreign Direct Investors in 1988," *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, May 1989, pp. 22-30.

vestment, accounted for $53 billion or 16 percent of the total. The distribution of banking assets of U.S. affiliates was significantly different from the aggregate as Japanese banks held 52 percent of the total foreign banking assets in the United States.[9]

[9] See Graham and Krugman, p. 22.

**Table 4.—Foreign Direct Investment in the United States, Selected Countries, 1988**

| Country | Billions of dollars | Percent |
|---|---|---|
| *All Countries* | $328.9 | 100.0 |
| Europe | 216.4 | 65.8 |
| European Community | 193.9 | 59.0 |
| United Kingdom | 101.9 | 31.0 |
| West Germany | 23.8 | 7.3 |
| Netherlands | 49.0 | 14.9 |
| Other E.C. | 19.2 | 5.8 |
| Other Europe | 22.5 | 6.8 |
| Japan | 53.4 | 16.2 |
| Canada | 27.4 | 8.3 |
| All Other | 31.7 | 9.6 |

Source: "Foreign Direct Investment in the United States: Position and Balance of Payment Flows, 1988." *Survey of Current Business,* U.S. Department of Commerce, Bureau of Economic Analysis, August, 1989, p. 52.

# II. PRESENT-LAW TAX RULES

## A. Overview

The United States exerts jurisdiction to tax all income, whether derived in the United States or not, of U.S. citizens, residents, and corporations. By contrast, the United States taxes nonresident aliens and foreign corporations only on income with a sufficient nexus to the United States.

The Internal Revenue Code generally provides two criteria for asserting jurisdiction to tax the income of nonresident aliens and foreign corporations (collectively, foreign persons), and a third criterion is found in treaties. Under the Code, certain gross income of a foreign person is subject to a 30-percent U.S. tax, without regard to deductions, if it is derived "from sources within the United States" (secs. 871(a) and 881) as that phrase is defined in Code sections 861-865. In addition, whether or not income is derived from U.S. sources as so defined, the Code asserts jurisdiction to tax the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States, computed on a net basis, in the same manner and at the same rates as the U.S. income of U.S. persons (secs. 871(b) and 882).

Under treaties, tax that would otherwise be imposed under the Code on certain U.S. income may be reduced or eliminated. In particular, the gross basis tax is sometimes eliminated or reduced. In addition, most U.S. income tax treaties provide that the "business profits" (or in some cases, the "commercial and industrial profits") of an enterprise carried on by a resident of the treaty partner are not taxable by the United States unless the enterprise carries on a business through a permanent establishment situated in the United States. Moreover, the United States often agrees in treaties to tax only so much of the business profits of the enterprise as is attributable to the U.S. permanent establishment.

## B. Source Rules

Depending upon the type, income may be sourced under the Code by reference, in whole or in part, to various factors: for example, the location or nationality of the payor, the location or nationality of the recipient (as in the case of certain ocean and space activities income), the location of the activities of the income recipient that generate the income (as in the case of services income), or the location of the assets (or the use of the assets) that generate the income (as in the case of rents or royalties).

### *Interest*

Interest is generally sourced domestically if it is from obligations of the United States or the District of Columbia, or on interest-bearing obligations of noncorporate U.S. residents or U.S. corporations. One exception covers amounts paid by U.S. persons that can show that at least 80 percent of their gross income from all sources for a 3-year testing period was active foreign business income. In that case, interest paid by the U.S. person is treated as foreign source if paid to an unrelated person, and as having a prorated source, based on the source of the income of the payor, if paid to a related person (sec. 861(c)(2)). Other exceptions from U.S. sourcing of interest paid by U.S. persons include interest on deposits with foreign commercial banking branches of domestic corporations or partnerships, and certain other amounts paid by foreign branches of domestic financial institutions.

### *Dividends*

Dividends from U.S. corporations are sourced domestically unless the payor has an election in effect to use the possessions tax credit (sec. 936), or the payor is a domestic international sales corporation (DISC) or former DISC and the dividends are attributable to qualified export receipts. Dividends from foreign corporations are sourced domestically to the extent treated (under certain dividends received deduction rules) as paid from earnings and profits accumulated by a domestic corporation subject to U.S. taxation. Dividends from a foreign corporation may also be sourced partly domestically if 25 percent or more of the foreign corporation's gross income during a 3-year testing period was effectively connected (or in some cases, deemed effectively connected) with the conduct of a trade or business within the United States, in which case the percentage of the dividend sourced as domestic is generally equal to the ratio of the gross income effectively connected with the conduct of a trade or business in the United States to the payor's entire gross income.

### *Personal services*

Compensation for labor or personal services performed in the United States is sourced domestically except compensation or labor that meets certain *de minimis* criteria.

### *Insurance income*

Underwriting income from issuing insurance or annuity contracts is sourced domestically if the contract is in connection with property in, liability arising out of an activity in, or in connection with lives or health of residents of the United States.

### *Transportation income*

Generally, 50 percent of income attributable to transportation which begins or ends in the United States is U.S. source.

### *Income from space or ocean activities or international communications*

In the case of a foreign person, generally no income from a space or ocean activity is sourced domestically. The same holds true for international communications income unless the foreign person maintains an office or other fixed place of business in the United

States, in which case the income attributable to that fixed place is sourced domestically.

### *Rents and royalties*

Rents or royalties from property (or interests in property) located in the United States, and rents or royalties for the use of or privilege of using intangible property in the United States are sourced domestically.

### *Dispositions of real property*

Gains, profits, and income from the disposition of a United States real property interest are sourced domestically.

### *Sales of personal property*

Subject to significant exceptions, income from the sale of personal property is generally sourced on the basis of the residence of the seller. Similarly, foreign currency gain or loss is generally sourced on the basis of the residence of the taxpayer or the qualified business unit of the taxpayer on whose books the asset, liability, or item of income or expense is property reflected. For these purposes, the term "nonresident" is defined to include any foreign corporation. The term "nonresident" is also defined to include any nonresident alien who does not have a "tax home" (as defined in sec. 911(d)(3)) in the United States.[10]

In the case of a nonresident making the sale, exceptions to the general rule can result in U.S. sourcing. Gain to the extent of prior U.S. depreciation deductions (including amortization or any other deduction allowable under the Code which treats an otherwise capital expenditure as a deductible expense) is sourced domestically. Gain of a nonresident on the sale of inventory property may be sourced domestically if title to the property passes in the United States or (unless the property is sold for use, disposition, or consumption outside the United States and an office or other fixed place of business of the taxpayer in a foreign country materially participated in the sale) if that person maintains an office or other fixed place of business in the United States, and the sale is attributable to that office or other fixed place of business. Receipts on sales of intangible property may be sourced like royalties to the extent payments are contingent on the productivity, use, or disposition of the intangible. Income from personal property sales attributable to the sale of goodwill is sourced in the country in which the goodwill was generated. Where inventory property is manufactured in the United States by the person that sells the property, a portion of the income from the sale will in all events be treated as U.S. source (sec. 863(b)).

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[10] U.S. citizens and residents (as resident is generally defined for Code purposes, per sec. 7701(b)) can, under certain circumstances, be considered "nonresidents" for sale income source purposes if they have a tax home in a foreign country and actually pay an income tax of at least 10 percent of the gain derived from the sale.

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### C. Net Income Taxation

#### 1. "Effectively connected" taxable income

As indicated above, the Code provides for taxing on a net basis the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States, in the same manner and at the same rates as the U.S. income of U.S. persons (secs. 871(b) and 882). Gross income of a foreign person that is not effectively connected with a U.S. business of the taxpayer is generally not taken into account in determining the rates of U.S. tax applicable to the income of the taxpayer from a U.S. business (secs. 871(b)(2) and 882(a)(2)).

***U.S. activity***

***Code—conduct of a trade or business within the United States***

In order for a foreign person to be taxed under the Code on a net basis, the person must be engaged in a U.S. trade or business. Partners in a partnership, and beneficiaries of an estate or a trust are treated as engaged in the conduct of a trade or business in the United States if the partnership, estate, or trust is so engaged (sec. 875).

The concept of "trade or business," long relevant for numerous purposes under the Code, generated a body of case law with respect to its application to foreign and other persons prior to the Foreign Investors Tax Act of 1966 ("the 1966 Act"). Basic issues involved included whether the income was from business as opposed to investing; [11] if from business, whether sufficient activities in connection with that business were performed in the United States; [12] and the nature of the agency relationship between persons who were present in the United States, performing functions of that business, and the foreign taxpayers.[13] The 1966 Act, which implemented a comprehensive review and revision of the U.S. taxation of foreign investment in the United States, in large part retained existing law as to whether a foreign person was conducting a trade or business in the United States.[14] However, the 1966 Act expressly addressed certain issues involving stocks, securities, and commodities in order to change or clarify then-existing law [15] and it introduced the statutory concept of "effective connection."

Generally under the statute, the term "trade or business within the United States" expressly includes the performance of personal

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[11] *Higgins v. Commissioner*, 312 U.S. 212 (1941).

[12] *Consolidated Premium Iron Ores, Ltd. v. Commissioner*, 28 T.C. 127, 150 (1957), *aff'd*, 265 F.2d 320 (6th Cir. 1959); *Continental Trading, Inc. v. Commissioner*, 265 F.2d 40 (9th Cir. 1959); *Spermacet Whaling & Shipping Co. v. Commissioner*, 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (2d Cir. 1960).

[13] *Adda v. Commissioner*, 10 T.C. 273 (1948), *aff'd*, 171 F. 2d 457 (4th Cir. 1948), *cert. denied*, 336 U.S. 952 (1949); *cf. Snell v. Commissioner*, 97 F.2d 891, 892-93 (5th Cir. 1938) ("It ordinarily is implied that one's own attention and effort are involved, but the maxim qui facit per alium facit per se applies, and one may carry on a business through agents whom he supervises.").

[14] "Whether a dealer or investment company is conducting a trade or business in the United States remains a question of fact to be determined under the rules under present law." H.R. Rep. No. 1430, 89th Cong, 2d Sess. 14 (1966). *See generally* Isenbergh, *The "Trade or Business" of Foreign Taxpayers in the United States*, 61 Taxes 972 (1983).

[15] *Adda v. Commissioner*, 10 T.C. 273 (1948), *aff'd*, 171 F. 2d 457 (4th Cir. 1948), *cert. denied*, 336 U.S. 952 (1949); *Nubar v. Commissioner*, 13 T.C. 566 (1949), *rev'd*, 185 F.2d 584 (4th Cir. 1950), *cert. denied*, 341 U.S. 925 (1951).

services within the United States at any time during the taxable year. However, if at no time during the taxable year does the taxpayer have an office or other fixed place of business in the United States through which or by the direction of which the transactions in stocks or securities are effected, the phrase "trade or business within the United States" excludes trading in stocks or securities through a resident broker, commission agent, custodian, or other *independent* agent (sec. 864(b)(2)(A)(i) and (C)). Similarly, if at no time during the taxable year does the taxpayer have an office or other fixed place of business in the United States through which or by the direction of which the transactions in commodities are effected, the phrase "trade or business within the United States" excludes trading in commodities through a resident broker, commission agent, custodian, or other independent agent (sec. 864(b)(2)(B)(i) and (C)). This last rule only applies, however, if the commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such a place.

In addition, the term excludes trading in stock or securities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions, if certain conditions are met. To meet these conditions, the foreign person must not be a dealer in stocks or securities. In addition, a foreign person meeting the conditions will either not be a corporation the principal business of which is trading in stocks or securities for its own account, with its principal office in the United States, or if it is such a corporation, it will also generally satisfy the definition of a personal holding company [16] (sec. 864(b)(2)(A)(ii)). A similar, but slightly different rule provides that for any foreign person that is not a dealer in commodities, the term excludes trading in commodities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions (sec. 864(b)(2)(B)(ii)). This last rule only applies, as above, if the commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such a place.

### *Treaties—carrying on business through a U.S. permanent establishment*

Under treaties, there is typically no U.S. taxation of business profits of the enterprise of a qualified treaty country resident unless the enterprise carries on business within the United States through a permanent establishment in the United States, that is, a fixed place of business through which the business of an enterprise

[16] In general, a personal holding company is a corporation at least 60 percent of the adjusted ordinary gross income of which is personal holding company income, and more than 50 percent of the stock of which is owned (directly, indirectly, or by attribution) during the last half of the taxable year by 5 or fewer individuals.

is wholly or partly carried on.[17] Treaties typically describe in more detail than the Code discussion of "conducting a trade or business within the United States" the characteristics relevant to determine whether something is a permanent establishment. The term typically is said to include especially a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. In the case of a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, such activity constitutes a permanent establishment, typically, only if it lasts more than a specified period (depending upon the treaty, falling between 4 and 24 months).

Notwithstanding the above rules, however, the term permanent establishment is usually deemed not to include the maintenance of a fixed place of business solely for the purpose of carrying on for the enterprise activities of a preparatory or auxiliary character. Treaties typically specify certain activities that may be deemed (alone or in combination) to be of this nature: for example, these generally include the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise; the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery; the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; or the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise.

Under treaties, a foreign person is usually not deemed to have a permanent establishment in the United States merely because it carries on business in the United States through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, where any person to whom the foregoing rule does not apply is acting on behalf of the foreign person and has and habitually exercises in the United States an authority to conclude contracts in the name of the foreign person, and that agent's activities on behalf of the foreign person go beyond the scope of what the foreign person could itself do in the United States without constituting a permanent establishment, the foreign person is deemed to have a permanent establishment in the United States in respect of any activities which the agent undertakes for the foreign person.

Further, treaties typically provide that the fact that a foreign company entitled to treaty benefits controls or is controlled by a U.S. company (or a foreign company carrying on business in the

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[17] In another context perhaps less related to issues of foreign investment in the United States, treaties use a second, similar, criterion for one country's (the source country's) assertion of jurisdiction to tax income from professional services and other activities of an independent character (including especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants) performed by a resident of the other country: namely, that the person have a "fixed base" regularly available in the source country for the purposes of performing the activities, and that the income be attributable to that fixed base.

United States) does not of itself constitute the U.S. company (or company carrying on business in the United States) a permanent establishment of the foreign company.

***Relationship of income to U.S. activities***

***Code—effective connection***

While the 1966 Act made only relatively minor adjustments in the definition of what constitutes the conduct by a foreign person of a trade or business within the United States, that Act introduced the concept that net basis taxation would apply only to the portion of the foreign person's income that was "effectively connected" with that trade or business. The Code provides rules and guidelines for determining whether income is so effectively connected.

***U.S. source income***

In the case of U.S. source income that, if not taxable on a net basis, would be subject to gross basis U.S. taxation (or in the case of certain U.S. source portfolio interest, no U.S. taxation) (such income is sometimes loosely described as "fixed or determinable, annual or periodical"), and in the case of capital gain or loss from U.S. sources, the factors taken into account in determining whether the income, gain or loss is effectively connected include whether the income, gain, or loss is derived from assets used in or held for use in the conduct of the U.S. trade or business, or whether the activities of the trade or business were a material factor in the realization of the income gain or loss (sec. 864(c)(2)). The Code states that due regard shall be given to whether or not the asset or income, gain, or loss was accounted for through the U.S. trade or business. In the case of U.S. source income, gain, or loss not described above (i.e., U.S. source income that is not fixed or determinable, annual or periodical), the Code provides that it shall all be treated as effectively connected with the conduct of a trade or business in the United States (sec. 864(c)(3)).

***Foreign source income***

*In general.*—Foreign source income of a foreign person effectively connected with the conduct of a trade or business in the United States may also be taxed by the United States, subject to a credit for foreign income taxes, if any, with respect to U.S.-effectively connected income (secs. 864(c)(4) and 906). The Code specifies those types of foreign source income that may be considered U.S.-effectively connected (sec. 864(c)(4)(A)). Thus, types of foreign source income not specified under these rules are generally exempt from U.S. tax. In the case of foreign persons other than insurance companies, foreign source income, gain, or loss is U.S.-effectively connected only if the person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable (sec. 864(c)(4)(B)). The amounts must be either rents, royalties, dividends, or interest, or amounts derived from the sale or exchange outside the United States of inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business.[18]

*Rents and royalties.*—If the income, gain, or loss consists of foreign source rents or royalties, then in order to be U.S.-effectively connected it must be income for the use of patents, copyrights, secret processes or formulas, good will, trade-marks, trade brands, franchises, or other like intangible properties (sec. 864(c)(4)(B)(i)). The rents or royalties must be derived in the active conduct of the U.S. trade or business. As a result of the Tax Reform Act of 1986 ("the 1986 Act"), all income of a nonresident from any sale of intangible property that is not inventory property, which sale is attributable to an office or other fixed place of business in the United States, is sourced domestically (sec. 865(e)(2)(A)). The same rule applies to inventory property unless the property is sold for use, disposition, or consumption outside the United States and an office or other fixed place of business of the taxpayer in a foreign country materially participated in the sale (sec. 865(e)(2)(B)). Thus, the Code sources domestically gains or losses on sales of intangible property that produce foreign source rents or royalties effectively connected with the conduct of a trade or business in the United States. These gains are therefore taxed by the United States without a foreign tax credit.

*Interest and dividends.*—If the income, gain, or loss consists of foreign source interest or dividends, then in order to be U.S.-effectively connected it must either be derived in the active conduct of a banking, financing, or similar business within the United States or be received by a corporation the principal business of which is trading in stocks or securities for its own account (sec. 864(c)(4)(B)(ii)). Similar to the case of intangible property, the Code sources domestically any gains or losses on sales of stocks and securities that produce foreign source dividends and interest that are effectively connected with the conduct of a trade or business in the United States, resulting in a U.S. tax with no foreign tax credit.

*Receipts from foreign subsidiaries.*—Notwithstanding the foregoing, foreign source income consisting of dividends, interest, or royalties is not treated as U.S.-effectively connected if the items are paid by a foreign corporation in which the recipient owns, directly, indirectly, or by attribution, more than 50 percent of the total combined voting power of the stock (sec. 864(c)(4)(D)(i)).

*Sales of inventory property.*—If the income, gain, or loss is derived from the sale or exchange of inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business, then in order to be U.S.-effectively connected it must be sold or exchanged outside the United States through the foreign person's U.S. office or other fixed place of business (sec. 864(c)(4)(B)(iii)). The income cannot be treated as effectively connected if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country participated materially in the sale or exchange.

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[18] Moreover, if the foreign person is a U.S.-controlled foreign corporation, none of its foreign source subpart F income may be treated as U.S.-effectively connected (sec. 864(c)(4)(D)).

As indicated above, under the 1986 Act income of a nonresident from any sale of inventory property (i.e., inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business), which sale is attributable to an office or other fixed place of business in the United States, is sourced domestically unless the property is sold for use, disposition, or consumption outside the United States and an office or other fixed place of business of the taxpayer in a foreign country materially participated in the sale. Thus, in any case where a foreign person is a "nonresident" for purposes of the source rules (and in most cases, foreign persons—i.e., nonresident aliens and foreign corporations—are indeed "nonresidents" for source rule purposes), all sales income from inventory property that could qualify as U.S.-effectively connected under section 864(c)(4) is sourced domestically. As such, it will be taxed as U.S.-effectively connected income, with no foreign tax credit, without regard to the rules for U.S. taxation of foreign source income. It may be possible, however, for a foreign person to be a "U.S. resident" within the meaning of the source rules, and to structure a transaction giving rise to foreign source income under the current source rules applicable to U.S. residents. In such a case, that foreign source income would be subject to U.S. taxation, but would be subject to a credit for foreign income taxes, if any.

*Office or other fixed place of business.*—Similar to the Code rules for determining whether a foreign person has a U.S. trade or business, and the treaty rules for determining whether a foreign person has a U.S. permanent establishment, the Code provides that in determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent is generally disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if either the agent has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person, or the agent has a stock of merchandise from which he regularly fills orders on behalf of the foreign person (sec. 864(c)(5)(A)). Assuming that an office or other fixed place of business does exist, income, gain, or loss is not considered attributable to it unless it was a material factor in the production of the income, gain, or loss, and it regularly carries on activities of the type from which the income, gain, or loss was derived (sec. 864(c)(5)(B)). Finally, in the case of any inventory property sales that are foreign sourced but U.S.-effectively connected, the income, gain, or loss treated as attributable to the U.S. office cannot be more than the amount of U.S. source income that would have been produced had the sale or exchange been made in the United States (sec. 864(c)(5)(C)).

*Insurance companies.*—The foreign source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code (subchapter L) may be treated as U.S.-effectively connected without regard to the foregoing rules, so long as such income is attributable to its United States business (sec. 864(c)(4)(C)). In addition, the net investment income of such a company which must be treated as effectively connected with the conduct of an insurance business within the United States is not less than the product of the company's "required U.S. assets" times either the applicable "domestic investment yield," or, if the taxpayer so elects, the "worldwide current investment yield" (sec. 842(b)). Required U.S. assets is an imputed asset amount, the product of multiplying the company's total insurance liabilities on U.S. business times an asset/liability percentage computed by the IRS based on domestic insurance industry data. Similarly, domestic investment yield is an imputed investment rate of return computed by the IRS based on domestic insurance industry data. By contrast, the optional worldwide current investment yield is the average worldwide investment rate of return experienced by the taxpayer.

*Timing rules*

Generally, income, gain, or loss for a particular year is not treated as U.S.-effectively connected if the foreign person is not engaged in a U.S. trade or business in that year (sec. 864(c)(1)(B)). However, in the case of payments for sales or exchanges of property, the performance of services, or any other transaction, which payments are deferred from one taxable year to a later taxable year, the determination whether such income or gain is taxable on a net basis is to be made as if the income were taken into account in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year (sec. 864(c)(6)). Also, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, and the property is disposed of within 10 years after the cessation, the determination of whether any income or gain attributable to the disposition of the property is taxable on a net basis must be made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a trade or business in the United States, and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year for which the income or gain is taken into account (sec. 864(c)(7)).

*Treaties—attribution*

Compared to the Code, treaties typically provide fewer express rules to determine whether income should be associated with the U.S. activity. Treaties often do provide, however, that no business profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise. In addition, the 1981 U.S. model income tax treaty (discussed in Part II.F., below) provides that the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment.

***Deductions***

*In general*

Effectively connected taxable income is computed taking into account deductions to the extent that they are connected with income which is effectively connected with the conduct of a U.S. trade or business. For this purpose, the Code generally leaves issues as to the proper apportionment and allocation of the deductions to regulations (sec. 873 and 882(c)(1)). With the exception of interest, deductions are generally allocated and apportioned to effectively connected income under general-purpose allocation rules, which are, for example, the same rules that govern the computation of U.S. source taxable income entering into the determination of a U.S. person's foreign tax credit limitations (Treas. Reg. sec. 1.882-4(c)(1)). The regulations applicable to deductions other than interest set forth general guidelines for allocating deductions among classes of income, and apportioning deductions between U.S.-effectively connected and non-effectively connected income, providing that in appropriate cases, deductions may be allocated on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space utilized, time spent, or gross income received (Treas. Reg. sec. 1.861-8(b) and (c)). More specific guidelines are provided for the allocation of research and experimental expenditures, stewardship expenses attributable to dividends received, legal and accounting fees, income taxes, losses on disposition of property, and net operating losses (Treas. Reg. sec. 1.861-8(e)).

***Interest deductions***

Interest deductions of foreign corporations are subject to a more detailed regulatory regime for allocation and apportionment to U.S.-effectively connected income (Treas. Reg. sec. 1.882-5). Three steps are required:

(1) The corporation's effectively connected assets, such as (in the case of a bank) loans generated with the active and material participation of U.S. branch personnel and administered by the U.S. branch, must be identified and their average total amount must be measured on a consistent basis, using either U.S. tax book value or fair market value, and using spot totals computed at the most frequent, regular intervals for which all asset data are available.

(2) The corporation must impute an amount of debt necessary to fund these effectively connected assets. In the words of the regulation, this theoretical slice of the corporation's debt is referred to as its "U.S.-connected liabilities."

(3) The corporation must construct one or more average rates of interest expense to associate with the U.S.-connected liabilities.

The deduction equals the product of the imputed debt and the constructed rate, or where the regulations provide for subdividing the debt into more than one piece and constructing a separate average rate for each piece, the deduction equals the sum of the products of the pieces of imputed debt and the applicable rates.

The corporation can elect one of two methods for determining its U.S.-connected liabilities. This amount may be set at either (a) 95 percent of the U.S. effectively connected assets in the case of a U.S. banking, financing, or similar business, and 50 percent of U.S. effectively connected assets in the case of any other U.S. business, or

(b) the same proportion of the corporation's effectively connected assets that its entire worldwide debt bears to its worldwide assets.

The corporation can also elect one of two methods for constructing the applicable rate of interest on its U.S.-connected liabilities. Under the first method, the "branch book/dollar pool" method, it is assumed that the applicable rates for computing the cost of the U.S.-connected liabilities are the actual rates incurred on the liabilities booked by the U.S. offices of the corporation, to the extent the U.S.-connected liabilities do not exceed the U.S.-booked liabilities. If there is such an excess—that is, if the corporation is using its foreign-booked liabilities to fund its U.S.-effectively connected assets—then the corporation computes the cost of the excess U.S.-connected liabilities by reference to the average cost of foreign-booked U.S. dollar liabilities. Where impossible to reasonably compute this rate, a reasonable approximation, such as LIBOR (London interbank offered rates) where appropriate, may be used. Where the excess is a de minimis amount, the average cost of U.S.-booked liabilities may be used.

The alternative method for constructing a rate to apply to the imputed amount of U.S.-connected liabilities is referred to as the "separate currency pools" method. Under this method, the corporation is treated as having borrowed a fraction of its U.S.-connected liabilities in a given currency in the same proportion as the ratio of its U.S.-booked liabilities in that currency to all of its U.S.-booked liabilities. A separate world-wide average cost is computed for each currency thus deemed to have been used by the corporation to fund its U.S.-effectively connected assets. The interest deduction is the sum of the products of the corporation-wide average interest rates for each currency times the theoretical fraction of its U.S.-connected liabilities in that currency. Where U.S.-booked liabilities in any particular currency (other than the corporation's home currency) amount to less than 3 percent of all U.S.-booked liabilities, the corporation may elect to use its worldwide U.S.-dollar rate in place of the worldwide rate in that currency. The election may not be changed for later years without the Commissioner's consent.

### *Allocation of deductions under treaties*

Treaties typically provide that the amount of business profits to be attributed to a U.S. permanent establishment are generally those which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. Treaties also generally provide that in determining the business profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, whether incurred in the United States or elsewhere. Such expenses may sometimes be specified in treaties to include one or more of the following: executive and general administrative expenses, research and development expenses, interest, or other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment).

### 2. Tax administration issues

#### *In general*

Net basis taxation of income from foreign inbound investment poses administrative issues that are in some ways different from those posed by the taxation of local U.S. investment. As a threshold matter, if a foreign person with U.S.-related income not subject to withholding determines that it has no U.S. trade or business (a determination calling for particularized analysis of facts and circumstances), and for that reason files no U.S. tax return, the IRS is foreclosed from challenging that determination in the ordinary return-examination process. Moreover, differing effective tax rates in different jurisdictions, or other factors, may create incentives to artificially shift income across borders. As indicated by the discussion of Treas. Reg. sec. 1.882-5 above, accurate allocation and apportionment of worldwide expenses to U.S. income depends on data which may be subject to foreign business and accounting conventions that take little or no account of U.S. tax or accounting rules. The ability of the IRS to examine or obtain materials created abroad is limited by obstacles resulting from, among other things, language differences, geographical distance, and different levels of foreign judicial support available to compel compliance with U.S. tax laws. The substantive U.S. tax rules applicable to inbound foreign investment are supported by certain Code and treaty provisions that respond to these administrative issues.

#### *Recharacterization of related-party transactions*

The Internal Revenue Service is authorized to distribute, apportion or allocate gross income, deductions, credits, or allowances between or among commonly controlled organizations, trades, or businesses as necessary to prevent the evasion of taxes or clearly to reflect income (sec. 482). Treasury Regulations state that the purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer (Treas. Reg. sec. 1.482-1(b)(1)). The IRS has broad authority to apply section 482 in any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer (Treas. Reg. sec. 1.482-1(c)). Treasury regulations prescribe separate detailed regimes for the determination of arm's-length transfer prices applicable to interest on loans or advances, performance of services, use of tangible property, transfer or use of intangible property, and sales of tangible property (Treas. Reg. sec. 1.482-2(a) through (e)).

Similarly, income tax treaties generally permit each country to alter the distribution of profits among members of a controlled group of entities in order to reflect the conditions that would be made between independent enterprises. As discussed below, the 1981 U.S. model treaty expressly permits application of internal law provisions, including section 482, that permit the distribution, apportionment, or allocation by the government of income, deductions, credits, or allowances between persons, whether or not residents of a treaty country, owned or controlled directly or indirectly by the same interests, when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons.

Despite the regulatory detail, what does and does not constitute an arm's-length arrangement remains fundamentally a question of fact, and is, of necessity, largely based on information available only from the taxpayer. The Treasury and IRS, in their 1988 white paper on intercompany pricing, reported on tax administration difficulties in determining arm's-length prices: [19]

> A significant threshold problem in the examination of section 482 cases has been IRS access to relevant information to make pricing determinations. In some cases, relevant information is not furnished by the taxpayer to the examining agent. In other cases, long delays are experienced by agents in receiving information, in most cases without explanation for the delays. In many cases, delays in responding to [International Examiner] requests for information exceed one year. Because of the emphasis upon timely closing of large cases in the recent past, section 482 cases have been closed without receiving necessary information or without the opportunity for agents to follow up on information that has been provided.
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> Because of the dramatic increase in recent years of direct foreign investment in the United States, the examination of transactions between foreign parents and their U.S. affiliates will become an increasingly more important part of the international examination program. A survey of rates of return on these companies based on IRS statistics of income ("SOI") data reveals a substantially lower than average profit in this country reported by these companies, which may involve transfer pricing policies.
>
> In practice, examinations of United States subsidiaries of foreign parents have developed into some of the Service's most difficult examinations. A primary reason for the difficulty is that agents are unable to obtain timely access to necessary data, which is typically in the hands of the parent company. In many cases, foreign parent companies refuse to produce this information upon request. An additional difficulty encountered by agents is that foreign parent corporations may not be subject to information reporting requirements similar to U.S. requirements.

The ability of the IRS to administer section 482 in cases involving inbound foreign investment is supported by information reporting, record maintenance, and related requirements, along with the applicable sanctions for noncompliance, recently revised in the Om-

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[19] U.S. Treasury Department (Office of International Tax Counsel and Office of Tax Analysis) and Internal Revenue Service (Office of Assistant Commissioner (International) and Office of Assistant Chief Counsel (International)), *A Study of Intercompany Pricing*, Discussion Draft, October 18, 1988, pp. 13-15 (references omitted).

nibus Reconciliation Act of 1989 (the "1989 Act") (see discussion below).

*Section 6038A—Reporting, recordkeeping and related requirements*

*Information reporting and maintenance*

Any corporation (U.S. or foreign) that conducts a trade or business in the United States and that is 25-percent owned by a foreign person ("reporting corporation") must furnish the IRS with such information as the Secretary may prescribe regarding transactions with certain foreign persons treated as related to the reporting corporation ("reportable transactions") (sec. 6038A).[20] Under current regulations, the IRS requires the annual filing of an information return reporting all related-party transactions (Treas. Reg. sec. 1.6038A-1).[21] In addition, a reporting corporation is required to maintain (or cause another person to maintain), in the location, in the manner, and to the extent prescribed by regulations, any records deemed appropriate to determine the correct tax treatment of reportable transactions (sec. 6038A(a)).

*Application of U.S. legal process to foreign persons*

The statutory scope of general IRS summons authority extends to certain persons that are not themselves subject to tax in the United States. Moreover, it is consistent with constitutional due process limitations for a court in the United States to subject a foreign person to personal jurisdiction in connection with commercial activities the person has purposefully caused within the court's jurisdiction.[22]

In addition, the Code provides that in order to avoid the consequences of the noncompliance rules (discussed below) with respect to certain reportable transactions, each foreign person that is a related party of a reporting corporation must agree to authorize the latter to accept service of process as its agent in connection with any request or summons by the IRS to examine books, records, or other materials, to produce such materials, or to take testimony related to any reportable transaction, solely for the purpose of determining the tax liability of the reporting corporation (sec. 6038A(e)(1)). Thus, assuming such authorization is given, IRS examination requests and summonses with respect to related-party transactions involving U.S. taxpayers can be served on related foreign persons that do not directly engage in trades or businesses in the United States.

*Sanctions for noncompliance*

*Monetary penalty.*—Failure to furnish the IRS with information or to maintain records as required under section 6038A(a) and (b) is sanctioned by a monetary penalty of $10,000, and additional penal-

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[20] Similarly, U.S. shareholders that control foreign corporations are required to report certain information with respect to such foreign corporations and all transactions with such foreign corporations (sec. 6038). Noncompliance with the requirements of section 6038 can be sanctioned by monetary penalties, as well as by the reduction or elimination of foreign tax credits allowed to U.S. shareholders that fail to report the required information (sec. 6038(c)).

[21] However, the regulation has yet to be amended to reflect the broadening in the 1989 Act of the definition of a related party.

[22] See, e.g., *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286 (1980).

ties are imposed if the failure continues more than 90 days after the IRS notifies the taxpayer of the failure (sec. 6038A(d)). The additional penalties are $10,000 for each 30-day period (or fraction thereof) during which the failure continues after the 90th day after IRS notification.

*Noncompliance rule.*—Failure of a related party to designate a reporting corporation as its agent for accepting service of process in connection with reportable transactions (as discussed above), or, under certain circumstances, noncompliance with IRS summonses in connection with reportable transactions, can result in the application of noncompliance rules in computing tax liability. For certain payments to related parties in connection with reportable transactions, this rule permits the IRS to allow the reporting corporation only those deductions and amounts of cost of goods sold as shall be determined by the Secretary in the Secretary's sole discretion, based on any information in the knowledge or possession of the Secretary or on any information that the Secretary may obtain through testimony or otherwise (sec. 6038A(e)).

***Treaty provisions regarding exchange of information***

Income tax treaties generally provide for the exchange of information between the tax authorities of the contracting states as is necessary for carrying out not only the provisions of the tax treaty but also the domestic tax laws of each country. For example, as specified in the U.S.-Canada income tax treaty, upon the request of the tax authorities of one country for information related to the tax liability in the requesting country of a resident of the second country, the second country is required to obtain information from its own resident in the same manner and to the same extent as if the requesting-country tax liability under examination were the tax of the second country and were being imposed by the second country. The second country would not be required to carry out administrative measures at variance with its own laws and administrative practices, to supply information that is not obtainable under the laws or in the normal course of the administration of the second country or the requesting country, or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy. The requesting country is required to treat as secret any information received under the treaty provisions, in the same manner as information obtained under the domestic laws of the requesting country.

The multilateral Convention on Mutual Administrative Assistance in Tax Matters, which was developed by the Council of Europe and the Organisation for Economic Co-operation and Development (OECD) and opened for signature in 1988, provides detailed rights and responsibilities regarding the exchange of information and related administrative matters. The terms of the Convention, which the United States signed in 1989 but has not yet ratified, are generally consistent with the information-exchange provisions of U.S. bilateral income tax treaties. However, the Convention imposes restrictions on two permitted uses of exchanged information that are not similarly restricted in the typical information-exchange provisions of U.S. bilateral income tax treaties. The Convention permits exchanged information to be disclosed in judicial proceedings and decisions, and used as evidence before a criminal court, only with the prior authorization of the country providing the information. The Convention permits signatory countries to mutually waive the prior-authorization requirements. As of January 1, 1990, only Sweden, Norway, the United States and Finland had signed the Convention. The Convention will not enter into force until instruments of ratification, acceptance or approval have been deposited by five signatories.

### *Section 982*

The Code provides a specific sanction for the failure to comply with certain IRS requests to produce foreign-based documentation. If, in connection with the examination of any item, a taxpayer fails to timely and substantially comply with a formal document request by the IRS for any relevant or material documentation which is located outside the United States, the requested documentation becomes inadmissible as evidence in any subsequent civil proceeding in which the examined item is an issue (sec. 982).

### *Sections 874 and 882(c)(2)*

The Code imposes a special prerequisite to the allowance of deductions and credits to foreign persons. A foreign person may receive the benefit of otherwise-allowable deductions and credits only by filing a true and accurate tax return, including all information deemed necessary by the Secretary for the calculation of such deductions and credits, which return complies with applicable rules and requirements relating to procedure and administration (secs. 874 and 882(c)(2)). Thus, if a foreign person engaged in a trade or business in the United States fails to file a tax return, the foreign person's tax liability would be determined without the benefit of deductions and credits.

### *Partnership withholding tax*

Although as a general rule foreign persons are not subject to withholding in the United States on income that is effectively connected with a U.S. business, partnerships that conduct a trade or business in the United States are required to pay a withholding tax with respect to a foreign partner's distributive share of the partnership's effectively connected taxable income (sec. 1446). A foreign partner is allowed a credit against its tax liability for its share of the withholding tax paid by the partnership (sec. 1446(d)(1)). Section 1446 was enacted in response to a concern that if the foreign partners failed to file returns and pay tax, the IRS was likely to find it virtually impossible to locate them and collect the tax.[23]

The section 1446 tax is required to be paid in the manner and at the time prescribed by Treasury regulations. A Revenue Procedure requires payment in four installments during the taxable year of the partnership in which the effectively connected taxable income is derived (Rev. Proc. 89-31, sec. 7.014, 1989-20 I.R.B. 140). The amount of the tax is the highest U.S. income tax rate applicable to

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[23] For this reason as well, the subchapter S election is not permitted to be made by a corporation with foreign shareholders (sec. 1361(b)(1)(C)).

each foreign partner (currently 28 percent in the case of noncorporate partners and 34 percent in the case of partners that are corporations), times the effectively connected taxable income of the partnership that is allocable to that partner (sec. 1446(b)(2)). The Treasury is authorized to impose penalties for failure to satisfy withholding tax liabilities, which penalties may be similar to those imposed on corporations for failure to pay estimated tax under section 6655.

### 3. Foreign investment in real property

#### *In general*

The Code contains a series of provisions collectively referred to as the Foreign Investment in Real Property Tax Act ("FIRPTA") (secs. 897, 1445, 6039C, and 6652(f)). FIRPTA taxes gains recognized by foreign persons that are attributable to dispositions of interests in U.S. real property. Prior to the enactment of FIRPTA in 1980, a foreign person was generally able to invest in U.S. real property without being subject to U.S. tax upon the eventual disposition of that investment.

#### *Amount of tax*

Section 897(a) provides that gain or loss of a nonresident alien individual or a foreign corporation from the disposition of a U.S. real property interest is taken into account as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with that trade or business. Thus, such gains are generally subject to tax at the same rates that apply to similar income received by U.S. persons. However, in the case of individual foreign investors, tax is imposed at a minimum rate of 21 percent of net real property gains (or 21 percent of alternative minimum taxable income, if less) (sec. 897(a)(2)(A)).

In the case of a foreign individual, a loss is taken into account under the FIRPTA provisions only to the extent that the loss would be taken into account under Code section 165(c), which limits deductions for an individual's losses to business losses, losses on transactions entered into for profit, and certain losses for casualty or theft (sec. 897(b)). Thus, for example, a loss on the sale of the taxpayer's personal residence is not taken into account.

#### *U.S. real property interest*

Under the FIRPTA provisions, tax is imposed on gains from the disposition of an interest (other than an interest solely as a creditor) in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U.S. Virgin Islands. The term "interest in real property" includes fee ownership and co-ownership of, leaseholds of, and options to acquire land or improvements thereon, as well as options to acquire leaseholds of land or improvements thereon (sec. 897(c)(6)(A)). Moreover, the term includes partial interests in real property such as life estates, remainders, and reversions. In addition, Treasury regulations provide that the term includes any direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, U.S. real property (Treas. Reg. sec. 1.897-

1(d)(2)(i)). Thus, if a foreign person owns a note that is secured by U.S. real property and as part of the note's interest component there is an "equity kicker," that note constitutes an interest other than solely as a creditor in U.S. real property, the disposition of which note would be subject to taxation under section 897(a). However, the regulations currently provide that if, instead of disposing of the note to a third party, the foreign person collects the principal balance plus interest (including that portion of interest which arises pursuant to the equity kicker) from the debtor, then no portion of the principal or interest so collected is taxable under FIRPTA (Treas. Reg. sec. 1.897-1(h)).

*U.S. real property holding corporations*

Also included in the definition of a U.S. real property interest is any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes that the corporation was not a U.S. real property holding corporation (USRPHC) at any time during the five year period ending on the date of the disposition of the interest (sec. 897(c)(1)(A)(ii)). Thus, gain on the disposition of an interest in a USRPHC is subject to tax under FIRPTA. An exception is made to the general rule if the investment is in the form of portfolio stock holdings in a publicly traded USRPHC. If any class of stock of a USRPHC is regularly traded on an established securities market, stock of that class is to be treated as a U.S. real property interest only in the case of a person that, at some time during the five-year period described above, held more than 5 percent of that class of stock (sec. 897(c)(4)).

A USRPHC is any corporation, the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of (i) its U.S. real property interests, (ii) its interests in foreign real property, plus (iii) any other of its assets which are used or held for use in a trade or business (sec. 897(c)(2)). Generally, for purposes of this asset test, a corporation that is a partner in a partnership takes into account its proportionate share of all assets of the partnership. Similar rules apply to trusts and estates in which a corporation has an interest (sec. 897(c)(4)(B)). Look-through rules also apply to a controlling interest (50 percent or more of the fair market value of all classes of stock) held by a corporation in a second corporation (foreign or domestic), with respect to assets held downward through the chain of ownership (sec. 897(c)(5)).

*Foreign corporations*

As indicated above, FIRPTA generally taxes foreign corporations on gains on the disposition of U.S. real property interests, but does not tax shareholders of foreign corporations on gains on the dispositions of their stock.

FIRPTA generally taxes foreign corporations on the distribution (whether or not in liquidation) to their shareholders of appreciated U.S. real property interests and on the sale of such interests in connection with their liquidation (sec. 897(d)(1)). In applying FIRPTA, the question whether or not gain is recognized by a foreign corporation on a distribution of appreciated U.S. real property is determined under regulations regarding the application of Code nonrecognition rules.

If a foreign corporation holds a U.S. real property interest and, under any treaty obligation of the United States, it is entitled to nondiscriminatory treatment with respect to that interest, then the foreign corporation may elect to be treated as a U.S. corporation, but only for purposes of FIRPTA (sec. 897(i)). The election may be made only if all shareholders of the corporation consent to the election and specifically agree that any gain upon the disposition of the interest that would be taken into account under FIRPTA will be taxable even if such taxation would not be allowed under a treaty to which the United States is a party. Additional rules governing the making of the election are contained in sections 1.897-3, 1.897-4, and 1.897-8T of the Treasury regulations. The election to be treated as a domestic corporation is the exclusive remedy for any person claiming treaty protection against discriminatory treatment as a result of FIRPTA.

*Partnerships, trusts, and estates*

Gain of a foreign investor on the disposition of an interest in a partnership, trust, or estate is subject to tax under FIRPTA to the extent that the gain represents the investor's pro rata share of appreciation in the value of the U.S. real property interests of the entity (sec. 897(g)).

*REITs*

Distributions to foreign shareholders by a real estate investment trust (REIT) are treated as gains from the sale of U.S. real property and subject to tax under FIRPTA to the extent of the shareholder's pro rata share of the net capital gain of the REIT on the disposition of U.S. real property interests (sec. 897(h)(1)). In the case of REITs controlled by U.S. persons, sales of the REIT shares by foreign shareholders are not subject to tax (other than in the case of distributions by the REIT) (sec. 897(h)(2)).

*Contributions to capital*

Gain is generally recognized by a foreign investor under FIRPTA on the transfer of a U.S. real property interest to a foreign corporation if the transfer is made as paid-in surplus or as a contribution to capital. Gain is recognized in the amount of the excess of the fair market value of the property transferred over the adjusted basis of the property and any other gain recognized by the transferor (sec. 897(j)).

*Nonrecognition rules*

As a general rule, nonrecognition provisions (e.g., sec. 351) apply under FIRPTA only in the case of an exchange of a U.S. real property interest for an interest the sale of which would be taxable under the Code (as modified by any treaty) (sec. 897(e)(1)). Similar rules, as provided by Treasury regulations, apply to U.S. real property interests that are transferred pursuant to a transaction that qualifies as a reorganization under section 368(a) of the Code (Treas. Reg. sec. 1.897-6T). These rules are generally designed to prevent a foreign investor from escaping U.S. tax by exchanging a taxable asset for a nontaxable asset in an exchange which would otherwise qualify for nonrecognition treatment under the Code.

### *Withholding on dispositions by foreigners of U.S. real property interests*

The Code generally imposes a withholding obligation when a U.S. real property interest is acquired from a foreign person (sec. 1445). Withholding is required unless one of five exemptions (discussed below) applies. The withholding obligation is generally imposed on the transferee; however in certain limited circumstances, an agent of the transferor or transferee is required to withhold. Any tax imposed on a foreign investor under FIRPTA in excess of amounts withheld remains the liability of the foreign investor.

#### *Amount withheld*

The amount required to be withheld on the sale by a foreign investor of a U.S. real property interest is generally 10 percent of the amount realized (gross sales price) (sec. 1445(a)). However, the amount withheld generally will not exceed the transferor's maximum tax liability if a certificate for reduced withholding is issued by the IRS (sec. 1445(c)(1)).

#### *Exemptions from withholding*

(1) *Transferor furnishes non-foreign affidavit.*—Withholding by the transferee generally is not required if the transferor furnishes to the transferee, under penalty of perjury, an affidavit stating that the transferor is not a foreign person and stating the transferor's taxpayer identification number ("non-foreign affidavit") (sec. 1445(b)(2)).[24]

(2) *Domestic corporation furnishes non-USRPHC affidavit.*—Withholding is not required on the disposition of an interest in a domestic corporation if the corporation furnishes an affidavit to the transferee stating, under penalty of perjury, that the corporation is not and has not been a U.S. real property holding corporation ("USRPHC") during the five-year period ending on the date of disposition of the interest ("non-USRPHC affidavit") (sec. 1445(b)(3)).[25]

(3) *Transferee receives qualifying statement.*—Withholding under section 1445(a) may be reduced or eliminated if the transferee receives a qualifying statement (sec. 1445(b)(4)). A qualifying statement may be issued by the IRS in cases where reduced withholding is appropriate, where the transferor is exempt from tax, or where either the transferor or the transferee has provided adequate secu-

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[24] Under regulations, the transferee is required, upon request, to furnish a copy of the non-foreign affidavit to the Internal Revenue Service (Treas. Reg. sec. 1.1445-2(b)(3)). The receipt of a non-foreign affidavit does not relieve the transferee of withholding responsibility if the transferee either has actual knowledge that the affidavit is false or receives a notice from an agent of the transferor or the transferee that the affidavit is false. A transferor's agent or transferee's agent that has actual knowledge that the affidavit is false yet does not give the required notice will be held liable for withholding as if the agent were the transferee, up to the amount of compensation the agent receives in connection with the transaction (sec. 1445(d)(2)).

[25] As in the case of a non-foreign affidavit, the receipt of a non-USRPHC affidavit will not relieve the transferee of withholding responsibility if the transferee either has actual knowledge that the affidavit is false or receives a notice from an agent of either party that the affidavit is false. The rules imposing a duty on agents to give notice in the case of a false affidavit, including the rule imposing withholding liability on agents when they fail to give the required notice, are the same in connection with false non-USRPHC affidavits as they are in connection with false non-foreign affidavits.

rity or has made other arrangements for payment of the tax (Treas. Reg. sec. 1.1445-3(a)).

(4) *Purchase price for residence below designated amount.*—Withholding is not required if the transferee intends to use the transferred real property as a residence, and the amount realized by the transferor on the disposition of the property is $300,000 or less (sec. 1445(b)(5)).

(5) *Stock transferred on established securities market.*—No withholding is required on a disposition of shares of a class of stock that is regularly traded on an established securities market. The exemption is not limited to stock traded on U.S. markets (sec. 1445(b)(6)).

### *Partnerships, trusts, estates, and corporations*

Special rules for withholding are necessary in the case of certain partnerships, trustees, executors, and corporations and for transferees of interests in partnerships, trusts, and estates. Generally, these special rules are set forth in Code section 1445(e) and applicable Treasury regulations.

*Income inclusions with respect to domestic partnerships, trusts, and estates.*—Withholding at a rate of 34 percent is generally required by a domestic partnership, a trustee of a domestic trust, or an executor of a domestic estate with respect to the gain realized on the disposition of a U.S. real property interest to the extent that such gain is includible in the distributive share of a foreign partner of the partnership, includible in the income of a foreign beneficiary of the trust or estate, or includible in the income of the grantor or other substantial owner of the trust or estate (under the grantor trust rules of the Code) (sec. 1445(e)(1)).[26] In this case, withholding is based on net gain realized rather than gross proceeds because the withholding agent in this instance, the partnership, trustee, or executor, has the information at its disposal to determine the amount of gain realized from the transaction.

*Distributions of U.S. real property interests by foreign corporations.*—Withholding is required by a foreign corporation on a distribution by the corporation of a U.S. real property interest when gain is recognized by the corporation under FIRPTA on the distribution (sec. 1445(e)(2)). The amount of tax to be withheld is 34 percent of the foreign corporation's gain.

*Distributions by domestic USRPHCs to foreign shareholders.*—Withholding is generally required by a domestic corporation that is (or, at any time during the previous five years was) a USRPHC when the corporation distributes property to a foreign shareholder in a corporate liquidation or in redemption of its stock (sec. 1445(e)(3)). Withholding will not be required, however, on a distribution by a domestic corporation when the stock liquidated or redeemed in connection with the distribution qualifies for the exemption from withholding for stock transferred on an established securities market. In general, the amount of tax to be withheld is 10

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[26] In order to prevent double withholding on the same item of income, however, domestic partnerships that are subject to the withholding requirements of section 1446 (see above discussion in Part II.C.2) are not also subject to the requirements of section 1445(e)(1) of the Code (Rev. Proc. 89-31, sec. 7.022, 1989-20 I.R.B. 140).

percent of the gross amount of the distribution received by the foreign shareholder.

*Taxable distributions by partnerships, trustees, and executors to foreign persons.*—Withholding is required by a domestic or foreign partnership, the trustee of a domestic or foreign trust, or the executor of a domestic or foreign estate, notwithstanding general Code rules, when the partnership, trustee, or executor makes a distribution of a U.S. real property interest to a foreign person that is a taxable distribution under the FIRPTA provisions taxing certain partnership, trust, and estate distributions (sec. 1445(e)(4)). In general, the amount of tax to be withheld is 10 percent of the fair market value of the distributed U.S. real property interest at the time of the distribution.

*Corporations electing domestic treatment.*—Foreign corporations electing to be treated as domestic corporations under Code section 897(i) are treated as domestic corporations for purposes of FIRPTA's withholding provisions. Thus, no withholding under section 1445 is required with respect to the disposition of a U.S. real property interest by a foreign corporation that has elected domestic corporate status under section 897(i).

***Reporting requirements and penalties for noncompliance***

Section 6039C of the Code authorizes the IRS to require reporting by foreign persons holding direct investments in U.S. real property interests, and imposes penalties for failure to file required reports. However, to date the IRS has found it unnecessary to impose such requirements, particularly in view of the compliance levels generated by the withholding provisions.

**4. Dual resident companies**

Prior to the 1986 Act, certain U.S. corporations subject to tax in a foreign country on their income without regard to its source or on a residence basis (so-called "dual resident companies") could consolidate with one set of affiliates in the United States and another set in a foreign country (e.g., the United Kingdom) simultaneously. A multinational business with such a structure could generate a large net loss, often through the use of interest deductions, in its dual resident company and use the loss to reduce the taxes on two separate streams of income subject to tax in two separate taxing jurisdictions. This technique was utilized by both U.S.- and foreign-owned multinationals.

The 1986 Act prevented the double use of losses that was previously available to those taxpayers. Under present law, if a U.S. corporation [27] is subject to a foreign country's tax on worldwide income, or on a residence basis, any net operating loss (generally referred to as a "dual consolidated loss") that it incurs is generally prohibited from reducing the taxable income of any other member of a U.S. affiliated group for that or any other taxable year. Regulations prevent use of a branch loss to offset income of the rest of

[27] For this purpose, the term "U.S. corporation" includes corporations organized or created in the United States or under the law of the United States or of any State (sec. 7701(a)(4)), certain stapled entities (sec. 269B), and certain subsidiaries formed to comply with the laws of a contiguous foreign country (sec. 1504(d)).

the corporation if the branch loss is eligible to reduce income of foreign affiliates (Treas. Reg. sec. 1.1503-2T(d)). Regulations also prevent avoidance of the rules by transfers of "tainted" assets between affiliates (Treas. Reg. sec. 1.1503-2T(e)).

On the other hand, regulations may also provide that the prohibition on use of losses does not apply to any loss which, under foreign law, does not offset the income of any foreign corporation. The Treasury has exercised this authority to permit the use of losses in a limited number of situations, including certain situations where (1) the dual resident company has no ability under foreign law to use the dual consolidated loss (i.e., it has no affiliates and the loss may not be carried back or forward to a different taxable year); (2) there exists an agreement between the United States and the foreign country which puts into place a taxpayer-elective procedure through which losses would offset income in only one country; (3) the dual resident company agrees to waive the statute of limitations on its U.S. tax return and to amend such return if the foreign loss carryover is used within 15 years; or (4) a qualified restructuring has taken place and there is no further ability to use a dual consolidated loss under foreign law (Treas. Reg. sec. 1.1503-2T(c)).

## D. Gross-Basis Taxation

The U.S. source income of a foreign person that is not effectively connected with a U.S. business generally is subject either to a gross-basis tax regime enforced by withholding obligations placed on payors of that income, or to no U.S. taxation.

### 1. Withholding tax on foreign persons

#### *In general*

##### *Code—30 percent taxation*

Where the U.S. source income received by a foreign person is interest, dividends, rents, royalties, or other similar types of income (known as fixed or determinable, annual or periodical gains, profits and income), the Code generally imposes a flat 30-percent tax on the gross amount paid if such income or gain is not effectively connected (or deemed effectively connected) with the conduct of a trade or business by the taxpayer within the United States (secs. 871(a) and 881).[28] This tax is generally collected by means of with-

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[28] Prior to the 1966 Act, flat gross-basis tax was imposed and withheld on fixed or determinable annual or periodical income below a threshold amount, and incomes above the thresholds were subject to progressive rates. The flat rate was set at 10 percent in the Revenue Act of 1936, raised to 15 percent in 1940, 27.5 percent in 1941, and 30 percent in 1942. Prior to the 1936 Act, fixed or determinable annual or periodical income of foreign persons was not subject to its own tax rate, and withholding rates were (as is the case today with ordinary wage withholding) set administratively. *See generally* Ross, *United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments,* 22 Tax L. Rev. 277, 280-83 (1967).

The House report on the 1966 Act included the following justifications for the 30-percent rate:

> The flat 30-percent rate of tax in the case of certain nonresident aliens has been applied under present law, and is continued under the bill, because the United States does not have jurisdiction over all of such an individual's income. These taxpayers are not allowed the deductions that are available to U.S. citizens and the 30-percent rate is considered an appropriate effective rate in such cases. ... It is also thought that applying the uniform flat rate with respect to income not effectively connected with a trade or

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holding by the person making the payment to the foreign recipient of the income (secs. 1441 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.

The United States generally does not tax capital gains of a foreign corporation that are not connected with a U.S. trade or business. Capital gains of a nonresident alien individual that are not connected with a U.S. business generally are taxed only if the individual was present in the United States for 183 days or more during the year. Such gains generally are taxed at a flat rate of 30 percent. Also subject to tax at a flat rate of 30 percent are any foreign person's gains from the sale or exchange of patents, copyrights, trademarks, and other like property, or of any interest in such property, to the extent the gains are from payments that are contingent on the productivity, use, or disposition of the property or interest sold or exchanged (secs. 871(a)(1)(D) and 881(a)(4)).

In addition, as discussed above, gains of a foreign individual or corporation on the disposition of U.S. real property interests are taxed on a net basis under FIRPTA, even if they are not otherwise effectively connected with a U.S. trade or business. Similarly, rental and other income from U.S. real property in some cases can be taxed, at the election of the taxpayer, on a net basis at graduated rates (secs. 871(d) and 882(d)).

The Code provides certain exceptions to the general 30-percent tax on gross income. A percentage of each dividend paid by a domestic corporation, 80 percent or more of the relevant income of which is active foreign business income, is exempt from tax (secs. 871(i)(2)(B) and 881(d)). In addition, certain investment income received by foreign governments is exempt from U.S. income tax (sec. 892). The types of income which are granted this exemption include the income received from investments in the United States in stocks, bonds, or other domestic securities, investments in the United States in financial instruments held in the execution of governmental financial or monetary policy, and interest on deposits in banks in the United States of moneys belonging to a foreign government. The exemption does not apply to income attributable to a commercial activity conducted by a foreign government. A similar exemption applies to investment income earned in the United States by international organizations.

Perhaps the most significant statutory exceptions are those regarding interest, which are discussed below.

### *Treaty rate reductions*

In addition to the statutory exemptions, some treaties may reciprocally reduce (or eliminate) the 30-percent withholding tax imposed by the United States on U.S. source income.[29] For example,

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business in the United States would tend to encourage investment here by foreigners. To the extent this occurs, there will, of course, be an improvement in our balance of payments.

H.R. Rep. No. 1450, 89th Cong., 2d Sess. 18 (1966).

[29] A table of applicable withholding tax rates from IRS Publication 515 is reproduced in the Appendix.

some U.S. tax treaties permit withholding tax to be imposed on dividends at rates not to exceed 5 percent for dividends paid to corporate shareholders owning more than a threshold amount (typically 10 percent) of the payor's stock, and 15 percent for all other dividends. Also, treaties may reduce or eliminate withholding tax on royalty payments, and may eliminate withholding tax on classes of income that are not specified in the treaty (e.g., Article 22 of the U.S.-U.K. income tax treaty). The effect of treaties on withholding tax on interest payments is discussed below.

Generally, the exemption or reduced rate of U.S. tax under treaties applies only to income that is not attributable to a trade or business conducted through a permanent establishment or fixed base located in the United States. (If the income *is* so attributable, it will generally be subject to net basis U.S. taxation.) Income that is not effectively connected with the conduct of a trade or business in the United States will generally not be treated as attributable to a U.S. permanent establishment (sec. 894(b)).

Under Treasury regulations, a foreign person eligible for a reduced rate of withholding under a tax treaty generally must file a statement with the withholding agent that sets forth the basis for the asserted reduction (Treas. Reg. sec. 1.1441-6). In the case of dividends, however, the withholding agent generally is authorized to withhold tax at the applicable treaty rate based only on the shareholder's address in a treaty country, with no statement required (see, e.g., Rev. Rul. 68-173, 1968-1 C.B. 626).

An alternative to the present address/self-certification system is the certification system, under which tax is withheld at a reduced rate only where the withholding agent is provided (prior to the income payment) a certification of eligibility for tax treaty benefits from the tax authorities of the income recipient's residence country. Another alternative is a refund system, under which tax is generally withheld at the statutory rate, and treaty beneficiaries are required to apply for refunds of the overwithheld tax, including at that time a certification of eligibility. A unique arrangement is currently in effect under an agreement with Switzerland: Where Swiss institutions receive income on behalf of nominees, and accordingly are unable to self-certify their beneficial ownership of the income and their eligibility for treaty benefits, the institutions themselves withhold tax from the nominees in the amount of the difference between the U.S. statutory rate and the treaty rate, and remit the difference either to the owner of the income or to the United States in accordance with the proof of treaty eligibility submitted by the owner to the Swiss institution.

The Treasury has considered such alternatives in an effort to prevent the abuses possible under the present address/self-certification method. However, none of the alternatives has been adopted. Treasury has informed Congress that it has found significant obstacles to the general use of each alternative in terms of administrability, effects on foreign investment flows to the United States, and possible effects on foreign treatment of U.S. overseas investment.[30]

### *Interest*

Although payments of U.S. source interest that is not effectively connected with a U.S. trade or business are subject to 30-percent withholding tax by the general rule of sections 871(a)(1)(A) and 881(a)(1), there are significant exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax (secs. 871(i)(2)(A) and 881(d)).[31] Original issue discount on obligations maturing in six months or less is also exempt from tax (secs. 871(a)(1)(A) and (C) and 881(a)(1)(3)).

Some U.S. tax treaties provide reciprocal exemptions from withholding tax on payments of interest (as in the case of treaties with France, Germany, the Netherlands and the United Kingdom). Others permit tax, but at reduced rates ranging from five percent (in the treaty with Switzerland) and 10 percent (in the treaty with Japan) to 15 percent (Belgium, Canada and Italy).[32]

#### *Portfolio interest*

Most significantly, the Code exempts from the 30-percent tax certain interest paid on portfolio obligations (secs. 871(h) and 881(c)). Portfolio interest is generally defined as any U.S. source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (1) on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) that is not received by a 10-percent shareholder, taking into account shares owned by attribution (sec. 871(h)). In the case of a corporate recipient of interest, however, the term portfolio interest generally also excludes any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person (sec. 881(c)(3)).

#### *Restrictions on bearer obligations*

In response to compliance problems associated with bearer obligations, U.S. law restricts the issuance of long-term bearer obligations by imposing a direct prohibition on the issuance of these obligations by the United States and its agencies or instrumentalities,[33] and by denying certain tax benefits to issuers and holders of other bearer obligations (secs. 103(b)(3), 149, 163(f), and 312(m)). In addition, the Code imposes an excise tax on issuers of bearer obligations that are registration-required obligations but are not

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[30] Testimony of O. Donaldson Chapoton, Acting Assistant Secretary of the Treasury (Tax Policy), before the Commerce, Consumer and Monetary Affairs Subcommittee of the House Committee on Government Operations, September 15, 1987.

[31] The House version of the 1966 Act would have changed this treatment, effective with a five-year delay (sec. 2(a) of H.R. 13103). However, the Act as passed did not include the House provision.

[32] The United States has generally terminated its prior tax treaty relationship with the Netherlands Antilles (effective January 1, 1988), but has permitted the provisions of the treaty that exempt interest from withholding tax to remain in effect.

[33] Sec. 28 of the Second Liberty Bond Act, ch. 56, 40 Stat. 288 (1917).

issued in registered form (other than obligations required to be registered under section 149(a)) (sec. 4701).

No sanction is imposed, however, on the issuance in bearer form of (1) obligations of a natural person, (2) obligations with a maturity at issue of not more than one year, and (3) obligations of a type not issued to the public. In addition, an exemption from the registration requirements is provided for certain obligations designed for issuance to foreign persons. Specifically, an obligation generally is not required to be issued in registered form if it is sold under procedures reasonably designed to prevent sale or resale to U.S. persons, it bears interest payable outside the United States only, and it indicates on its face that U.S. holders are subject to penalties. However, the Secretary of the Treasury has discretion to require registration of these obligations designed for foreign markets (and short-term and non-public obligations).

**2. Excise tax on insurance premiums paid to foreign insurers**

The Code provides for an excise tax equal to a flat percentage of premiums paid on policies of insurance, indemnity bonds, annuity contracts, and policies of reinsurance issued by a foreign insurer or reinsurer to or for or in the name of a domestic corporation or partnership, or a U.S. resident individual with respect to risks wholly or partly within the United States, or to or for or in the name of any foreign person engaged in business within the United States with respect to risks within the United States (sec. 4371). The tax is 4 percent of the premium paid on a policy of casualty insurance or indemnity bond, and generally 1 percent on all other premiums. The excise tax does not apply to an amount effectively connected with the conduct of a trade or business in the United States (unless such amount is exempt from net basis U.S. tax under a treaty).

The tax is waived in U.S. tax treaties with the United Kingdom, France, Italy, Cyprus, and certain other countries. The tax would also be waived upon entry into force of certain treaties and draft treaties awaiting further action prior to ratification, including the as yet unsigned treaty with Germany. The 1984 treaty with Barbados contains such a waiver as well, but in 1988 that treaty provision was overridden by statute, effective January 1, 1990 (sec. 6139 of the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act")). Generally, these treaty waivers include an anti-conduit rule denying the benefit of the exemption to premiums covering risks that are reinsured with a person not entitled to a similar treaty exemption. (The U.K. treaty, however, has no anti-conduit rule.)

**3. Second level taxes on foreign corporations**

*Overview*

A U.S. corporation owned by foreign persons is subject to income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As discussed above, when the shareholders are foreign, the second level tax is imposed at a flat rate and collected by withholding. Similarly, as discussed above, interest payments made by a U.S. corporation to foreign creditors (including related foreign creditors) are subject to a U.S. withholding tax in certain circumstances. Comparable to second level taxes, the branch profits tax and the branch level interest tax are generally imposed by the Code on foreign corporations engaged in a U.S. trade or business, measured by amounts of U.S. earnings and profits that are shifted out of, or amounts of interest deducted by, the U.S. branch. In addition, where a foreign corporation is not subject to the branch profits tax as the result of a treaty, it may be liable for withholding tax on actual dividends it pays to foreign shareholders.

*Branch profits tax*

Section 884(a) of the Code imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount." The "dividend equivalent amount" is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected (or treated as effectively connected) with a U.S. trade or business, subject to two adjustments (detailed below).

The following earnings and profits attributable to income effectively connected with a U.S. trade or business are excluded from the imposition of branch profits tax: (1) Certain earnings derived by foreign sales corporations; (2) earnings derived by foreign transportation carriers that are exempt from U.S. tax by reciprocal exemption; (3) earnings derived from the sale of any interest in U.S. real property holding corporations; (4) earnings derived by corporations satisfying certain ownership and income requirements that are organized in certain U.S. possessions; and (5) earnings derived by certain captive insurance companies that are treated as deriving income effectively connected with a U.S. trade or business solely because of a special election.

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted in two circumstances. These adjustments identify changes in a branch's U.S. net equity (the difference between a branch's assets and liabilities treated as connected with its U.S. trade or business) that reflect profit remittances during a taxable year. The first adjustment to the dividend equivalent amount reduces the tax base to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the tax base to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

In measuring the changes in U.S. net equity during a taxable year, the adjustments to a branch's effectively connected earnings and profits account for only the assets and liabilities that are treated as connected with the conduct of the branch's U.S. trade or business. The determination of these assets and liabilities is consistent with the rules used in allocating deductions for purposes of computing taxable income.

Since the taxable base is determined on the basis of effectively connected earnings and profits, the computation of U.S. net equity likewise is based on the earnings and profits value of the branch's assets and liabilities connected with its trade or business. For example, in computing an increase or decrease in U.S. net equity, a branch that claims accelerated depreciation on its assets for the purpose of calculating taxable income is required to make its branch-level tax computation using the assets' bases for earnings and profits purposes.

Treaties may limit the scope of the branch profits tax so as to allow its imposition only upon that portion of the business profits of a foreign corporation attributable to its U.S. permanent establishment which represents a dividend equivalent amount (Treas. Reg. sec. 1.884-1T(h)(4)(ii)(B)).

The rate of tax generally imposed by the branch profits tax provision on the dividend equivalent amount is 30 percent. This rate may be reduced by a U.S. income tax treaty unless the foreign corporation is not a qualified resident of the treaty country (discussed below). Under treaties, the rate is typically the same as the rate on "direct" investment dividends, (e.g., dividends paid to 10-percent-or-more corporate shareholders) (sec. 884(e)(2)(A)(ii)). The Treasury has further determined that as to pre-1986 treaties providing for nondiscrimination (see Part II.F.), imposition of the branch profits tax will be waived in order to preserve nondiscriminatory treatment (Treas. Reg. sec. 1.884-1T(h)(3)).

*Branch-level interest tax*

Interest paid by a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation and, hence, is U.S. source and subject to U.S. withholding tax of 30 percent (if the interest is paid to a foreign person), unless the tax is reduced or eliminated by a specific Code or treaty provision (sec. 884(f)(1)(A)). To the extent a U.S. branch of a foreign corporation has allocated to it under regulation section 1.882-5 an interest deduction in excess of the interest actually paid by the branch (this generally occurs where the assets of the U.S. branch are being funded, in part, by liabilities incurred outside the branch), the excess is treated as if it were interest paid on a notional loan to a U.S. subsidiary (the U.S. branch, in actuality) from its foreign corporate parent (the home office) (sec. 884(f)(1)(B)). This excess is also subject to the 30-percent tax, absent a specific Code exemption or treaty reduction.

For purposes of determining whether the tax on the excess interest is to be reduced or eliminated by treaty, the applicable income tax treaty is the one between the United States and the country of the corporation's home office. Any treaty benefits available in this case are, however, subject to prohibitions against treaty shopping. In the case of U.S. withholding tax on interest actually paid by a branch to a foreign recipient, the appropriate treaty is that between the United States and the country of the recipient, subject again to the prohibition against treaty shopping.

*Qualification for branch tax relief under treaties*

In general, the branch profits tax and branch-level interest tax do not apply where their application would be inconsistent with a U.S. income tax treaty obligation, whether under a pre-1986 or post-1986 treaty. However, the branch profits tax yields to treaties only where a foreign corporation with a U.S. branch is a "qualified resident" of a treaty country (i.e., the corporation is not treaty shopping).

A foreign corporation is considered to be treaty shopping in either of two cases. Treaty shopping occurs if 50 percent or more of the stock of the foreign corporation is owned directly or indirectly by individuals who are not residents of the United States or the treaty country, or U.S. citizens. A foreign corporation is also treaty shopping where 50 percent or more of its income is used to meet liabilities to persons who are not residents of the country in which the corporation is a resident and who are not U.S. citizens or residents (this is referred to as a "base erosion" rule).

However, if a foreign corporation's stock is primarily and regularly traded on an established securities market in the country under whose treaty it claims benefits as a resident, then the corporation is considered a qualified resident of that country. Additionally, if a foreign corporation's parent is organized in either the United States or the same country as its subsidiary corporation, and the parent corporation's shares are primarily and regularly traded on an established securities market in that country, then the subsidiary corporation is considered a qualified resident of the country for purposes of the country's treaty with the United States.

With respect to the branch-level tax on interest, U.S. treaty obligations are overridden if either the payor of interest or the recipient of interest is treaty shopping under the rules discussed above.

### *Second level withholding taxes*

As explained above, if the branch profits tax is prohibited by a treaty between the United States and the country of residence of a foreign corporation, then second level withholding taxes are imposed on dividends paid by the foreign corporation in certain situations. In such a case, dividends paid by the foreign corporation will be subject to withholding tax in the United States if at least 25 percent of the corporation's gross income from whatever source for the three-year period ending with the close of the taxable year immediately preceding the taxable year during which the dividend is paid was effectively connected (or treated as effectively connected) with the conduct of a U.S. business. The percentage of the dividend which is treated as U.S. source income and is thus subject to the withholding tax is the ratio of effectively connected gross income to total gross income during the three-year period.

The second level withholding tax is generally imposed at the normal statutory withholding tax rate of 30 percent for non effectively connected income, and is levied on the gross amount of the dividend. This rate can be reduced by treaty.

The second level withholding tax is a vestige of the pre-1986 Code, which imposed no branch tax. Where a foreign corporation conducted its U.S. operations through a U.S. branch, the second level withholding taxes of prior law were designed to operate (in the absence of a branch tax) like the dividend and interest withholding taxes that would have applied had the U.S. operations been conducted through a separately incorporated U.S. subsidiary.

### 4. Earnings stripping

In cases where treaties eliminate tax on interest paid by a corporation to certain related persons, the Code generally provides for denial of interest deductions at the corporate level to the extent that its net interest expenses exceed 50 percent of adjusted taxable income. The amount of the disallowance is limited, however, by the amount of tax-exempt interest paid to related persons (sec. 163(j)).[34]

A taxpayer's adjusted taxable income is generally its taxable income computed without regard to net interest expense, net operating loss carryovers, or any deduction allowable for depreciation, amortization, or depletion, and computed with such other adjustments as are provided by regulations. A recipient is related to the payor of interest if the recipient and payor would be treated as related under the rules of section 267(b) or subject to the controlled partnership rules of section 707(b)(1).

If a treaty between the United States and any foreign country reduces, but does not eliminate, the U.S. tax imposed on interest that the taxpayer pays to a related person, the interest is subject to disallowance in the same proportion as the treaty's rate reduction (from the 30-percent rate) bears to 30 percent.

In determining the tax-exempt status of any interest recipient, look-through rules apply to pass-through entities (such as partnerships, regulated investment companies and real estate investment trusts), such that the deduction limitation applies separately to the beneficial interest held by each owner, in accordance with the separate tax-exempt status of each owner. However, whether or not a pass-through entity is treated as related to the U.S. corporation is generally determined at the entity level.

In the case of corporations that form part of an affiliated group (whether or not such corporations file a consolidated return), the earnings stripping limitation generally applies on a group basis.

Any amount of interest disallowed is permitted to be carried forward as disqualified interest to the following taxable year. In addition, a taxpayer is permitted to carry forward any excess limitation from its three most recent taxable years. The term excess limitation means the excess (if any) of 50 percent of the adjusted taxable income of the corporation over the corporation's net interest expense.

A corporation's interest deductions for a taxable year will not be denied under the earnings stripping provision unless the ratio of debt to equity of the corporation as of the close of the taxable year (and on such other days during the taxable year as regulations may prescribe) exceeds 1.5 to 1. The ratio of debt to equity means the ratio which the total indebtedness of the corporation bears to the sum of its money and all other assets less such total indebtedness, taking into account such adjustments as the Secretary may prescribe in regulations. For this purpose, the amount taken into account with respect to any asset is that asset's adjusted basis for purposes of determining gain.

### E. Estate and Gift Taxation

U.S. estate and gift taxation applies not only to citizens and residents of the United States, but also to nonresident alien transfer-

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[34] This rule also applies to interest paid to domestic related persons that are exempt from tax on the income.

ors. For U.S. citizens and residents, the gross amount subject to estate and gift tax is determined by reference to all property, wherever situated (secs. 2031(a) and 2511(a)). For nonresident aliens, the gross amount subject to estate tax is determined by reference only to property situated in the United States (sec. 2103). Property situated in the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments (sec. 2104(c)), but does not include either bank deposits or portfolio obligations, the interest on which would be exempt from U.S. income tax under section 871 (sec. 2105(b)). More importantly, stock owned and held by a nonresident alien is treated as property situated in the United States if and only if the stock was issued by a domestic corporation (sec. 2104(a); Treas. Reg. sec. 20.2104-1(a)(5)). Accordingly, a nonresident alien may hold U.S. property indirectly through a foreign corporation, and thereby generally avoid any application of U.S. estate taxation. The taxable estate is determined by allowing a deduction for a ratable portion of worldwide deductions against the U.S. estate (sec. 2106(a)(1)).

Nonresident aliens are generally subject to gift tax only on the transfer of tangible property situated in the United States (sec. 2501(a)(2)). Accordingly, a nonresident alien may hold U.S. property indirectly through any corporation, domestic or foreign, and thereby generally avoid any application of U.S. gift taxation.

Treaties may reduce U.S. taxation even in cases where some property is held directly or through a U.S. corporation, by reciprocally eliminating U.S. tax on estates of foreign persons except insofar as the estate comprises U.S. real property or business property of a U.S. permanent establishment.

U.S. estate and gift tax on the U.S. property of a foreign decedent is imposed at the same rates as tax on the worldwide property of a U.S. decedent. The credits permitted, however, are different. The Federal estate and gift taxes are unified, so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. The gift and estate tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 55 percent on taxable transfers over $3 million (50 percent on taxable transfers over $2.5 million in the case of individuals dying and gifts made after 1992). The estate and gift tax rate for transfers in excess of $10 million is increased by five percent until the benefits of the unified credit and graduated brackets are recaptured.

Estates of U.S. citizens and residents are allowed a unified credit of $192,800 in determining estate and gift tax. Under the Code, estates of foreign individuals are allowed a basic credit of $13,000 in determining estate tax. No similar credit is available to nonresident aliens in determining gift tax. Under treaties, the amount of credit may be increased to a pro rata share of $192,800, based on the fraction of the worldwide estate subject to U.S. tax.

### F. Tax Treaties and Foreign Tax Laws

The internal tax laws of most countries provide some sort of regime for taxing either the foreign income of domestic persons, the domestic income of foreign persons, or both. In either case, the tax base and rates of tax under the laws of other countries are likely to be different than those used with respect to the same income by the United States. In particular, some other countries exempt certain foreign income of domestic persons from tax. In most cases, the U.S. income of a foreign person, the foreign income of a U.S. person, or both are potentially subject to two autonomous tax systems, each of which is at best designed to mesh with the other system only in broad general terms. Perceived overtaxation or undertaxation of such income can potentially result. For this and other reasons, tax rules governing U.S. income of foreign persons may be determined, not only by Federal, State, and local tax laws in the Code and other statutes, but also by bilateral treaties or other agreements between the United States and foreign countries. The United States is currently a party to over 35 bilateral income tax treaties, over 15 estate and gift tax treaties, approximately five agreements for the exchange of taxpayer information, and certain other treaties (e.g., friendship, commerce, and navigation treaties) that may affect tax relations with residents or nationals of other countries. The United States has also signed an as-yet unratified multilateral treaty on exchange of taxpayer information.[35]

The Constitution provides that "Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land." U.S. Const. art. VI, cl. 2. The Supreme Court has interpreted this language to mean that the internal U.S. legal status of treaties is equivalent to that of Federal statutes.[36] A provision of the Internal Revenue Code adopted in 1988 codifies the applicability of this principle to the relationship of treaties and the Code (sec. 7852(d)(1)).

***Reciprocal reductions of internally imposed source country tax***

Although statutes and treaties are in one sense of equal stature, the effect of applying any treaty provision to a particular taxpayer can generally only be to reduce, in the case of a foreign person, the U.S. tax that would otherwise be collected from that person were the Code rules to be applied without regard to the treaty.[37] Moreover, because tax treaties are negotiated agreements between two governments, and because of the interest each government has in the taxation of both inbound investment by foreign persons and outbound investment by domestic persons, tax treaties are in some sense reciprocal; for example, in most instances, a treaty provision that by its terms reduces Code taxation of a foreign person also reduces by its terms, in an identical or an analogous fashion, the taxation by the treaty partner of U.S. persons.

In practice, the types and amounts of income of each country's residents subject to taxation in the other country, and the internal

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[35] Convention on Mutual Administrative Assistance in Tax Matters (1988).

[36] *See generally Reid v. Covert,* 354 U.S. 1, 18 (1957); *Whitney v. Robertson,* 124 U.S. 190, 195 (1888); Henkin, *The Constitution and United States Sovereignty: A Century of Chinese Exclusion and its Progeny,* 100 Harv. L. Rev. 853, 872 (1987); L. Henkin, *Foreign Affairs and the Constitution* 163-64 (1975); *Restatement (Third) of the Foreign Relations Law of the United States* sec. 115, comment a. (1987).

[37] Under the 1988 Act, any taxpayer that claims eligibility for treaty relief from U.S. statutory law is required (absent regulatory waiver) to disclose such claim or position to the IRS (sec. 6114).

tax laws applicable to that income, will be different. Therefore, the facially reciprocal terms of a treaty represent a decision on the part of each government that the overall benefits it receives, for example in the form of reduced foreign taxation of its residents (possibly leading to reduced crediting of foreign taxes against domestic tax liabilities), in the form of increasing desired capital inflows, or in the form of increased extraterritorial enforcement capability, is sufficient to compensate for the costs incurred, for example in the form of reduced tax receipts from foreign persons.

The mechanism for adopting a treaty is different from that for creating a Federal statute. Treaties must be negotiated between the Executive branch and a foreign government, consented to by two-thirds vote of the Senate, and ratified by the President; statutes must be passed by both Houses of Congress and signed by the President, or passed over the President's veto by two-thirds vote of both Houses. Moreover, entry into a treaty creates U.S. obligations under international law which may persist regardless of changes in internal law.[38] In addition, the nature of a treaty as a bargain with another government may be said to create expectations on the part of the other government concerning the implementation and duration of the treaty bargain. Under the internal laws of two of the countries with which the United States has entered into treaties, treaties gives rise to internal legal rights that are said to be superior to the dictates of certain internal legislation.[39]

Treaties accomplish the goal of avoiding double taxation by limiting the amount of tax that may be imposed by one treaty country on the income earned by residents of the other treaty country, by ensuring the creditability of taxes imposed by the treaty country where income was earned (the "source country") in computing the amount of tax owed by a resident of the other treaty country to his or her residence country (or by exempting from residence country tax income derived from sources in the other treaty country), and by providing procedures under which inconsistent positions taken by both treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries. Treaties prevent fiscal evasion by providing for exchange of taxpayer information between the two taxing authorities, and in some cases by providing that each tax authority will assist the other in revenue collection. In addition, treaties typically provide that nationals of one treaty country may not be subject by the other treaty country to taxes or requirements connected therewith that are other or more burdensome than those applicable to similarly situated nationals of the other treaty country. Generally, treaties may be used by residents or citizens of one country to reduce the taxes that would otherwise be payable to the other country under its internal

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[38] *Restatement (Third) of the Foreign Relations Law of the United States* sec. 115, comment b. (1987).

[39] The constitutions of the Netherlands and France are said to provide for such superiority of treaties in certain contexts. Statuut Ned. art. 94 (Neth.) ("Statutory regulations in force within the Kingdom shall not be applicable if . . . in conflict with provisions of treaties that are binding on all persons"); *id.* art. 91 sec. 3 ("provisions of a treaty that conflict with th[is] Constitution . . . may be approved"); Const. tit. VI, art. 55 (Fr.) (duly ratified treaties "have an authority superior to that of laws"); as translated in Henkin, *The Constitution and United States Sovereignty: A Century of Chinese Exclusion and its Progeny,* 100 Harv. L. Rev. 853, 871 n.78 (1987).

laws. Treaties generally do not operate to increase the amount of taxes that would otherwise be due under internal law.

### *United States tax treaty policy*

#### *In general*

The preferred tax treaty policies of U.S. Administrations have been expressed from time to time in model treaties and agreements. In addition, the OECD has published model tax treaties.[40] The Treasury Department, which together with the State Department is responsible for negotiating tax treaties, last published a proposed model income tax treaty in June 1981, and a model estate, inheritance, gift, and generation-skipping transfer tax treaty in 1980. It is understood that the Treasury's current working model (that is, its current preferred income tax treaty negotiating position) includes provisions different from those in the 1981 model, in part due to the substantial changes in U.S. statutory international tax provisions since mid-1981.[41] The OECD last published a model income tax treaty in 1977 ("the OECD model") and a model estate, inheritance and gift tax treaty in 1983. Both OECD model treaties are accompanied by extensive commentary, expressing views of the OECD Committee on Fiscal Affairs and, where relevant, separate views of particular member countries. In addition, the OECD Committee on Fiscal Affairs publishes from time to time more detailed reports on particular international tax issues.[42]

#### *Treasury's model income tax treaty*

The 1981 U.S. model income tax treaty contains many provisions of particular significance with respect to inbound investment.

*Residence.*—The model generally treats as a resident of a treaty country any person who, under the laws of that country, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. However, the concept of treaty country resident excludes any person who is liable to tax in that country in respect only of income from sources in that country or capital situated therein.

In the case of income derived or paid by a partnership, estate, or trust, the term applies only to the extent that the income derived by that entity is subject to tax in that country as the income of a resident. Thus, under the model, income of a treaty country partnership generally would not be treated as income of a treaty country resident except to the extent that either the partnership is taxed on a residence basis by the treaty country or its income is

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[40] The United Nations has also published a model treaty for use between developed and developing countries. However, this model is intended to apply to situations where emphasis is typically laid on the capital importing interests of the *developing* country and the capital exporting interests of the developed country. Thus, the U.N. model may have limited applicability to a discussion of taxing capital imported into the United States from abroad.

[41] For example, in June 1988 the Treasury completed a protocol with France, since ratified. The protocol amended the existing French treaty and protocols largely for the purpose of conforming them to the 1986 Act changes in the Code. In doing so, it necessarily departed in some ways from the 1981 model.

[42] For example, the OECD's 1987 paper entitled *Thin Capitalisation* figured heavily in the statement of managers explaining the relationship to treaties of the earnings stripping provisions in the 1989 Act (H.R. Rep. No. 101-386, 101th Cong., 1st Sess. 564-70 (1989)).

taxed in the hands of its partners on a residence basis by the treaty country.

Where the above rules treat a company (i.e., a corporation or an entity treated as such for tax purposes) as a resident of both treaty countries, then if it is created under the laws of only one of the countries or one of its political subdivisions, it is deemed a resident of that country. Where the above rules treat a person other than an individual or company as a resident of both countries, the model calls for the competent authorities (i.e., the tax administrators) of each country to settle the question by mutual agreement.

*Business profits attributable to a permanent establishment.*—The permanent establishment and business profits rules in the model treaty generally conform to the existing treaty provisions described above in Part II.C.2. The model specifies that a duration of more than twelve months is necessary before treating a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, as a permanent establishment (art. 5.3). Where the OECD model expressly provides for the allocation of worldwide executive and general administrative expenses in determining business profits attributable to a permanent establishment, the U.S. model also specifies research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part of the enterprise that includes the permanent establishment) (art. 7.3).

*Dividends.*—The model permits taxation of dividends by the residence country of the payor (sometimes referred to as the "source country"), but limits the rate of source country tax in cases where the beneficial owner of the dividends is a resident of the other treaty country.[43] In that case, the model allows not more than a 5 percent gross-basis tax if the beneficial owner is a company which owns at least 10 percent of the payor's voting stock, and in any other case not more than a 15 percent gross-basis tax. (Under the OECD model, the 5 percent rate is not available unless the beneficial owner of the dividends is a company other than a partnership which holds directly at least 25 percent of the capital of the dividend payor.) The term "dividend" as used in the model is limited to income from shares or other rights, not being debt-claims, participating in profits, and income from other corporate rights which is subjected by the source country to the same tax treatment as income from shares. The model also allows for so-called "second level withholding taxes" (see Part II.D.3. above) provided that the dividends are paid out of profits attributable to a permanent establishment in the taxing country, and the gross income of the dividend payor attributable to such permanent establishment constituted at least 50 percent of the company's gross income from all sources. However, in light of the Treasury's apparent goal of nego-

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[43] This limitation does not apply to dividend income attributable to a source country permanent establishment through which a resident of the other treaty country carries on business, or to income attributable to a fixed base from which a resident of the other treaty country performs independent services. In the case of such income, it would be subject to the ordinary net-basis taxation rules applicable to any other income attributable to the permanent establishment or fixed base.

tiating treaties allowing for a branch profits tax,[44] this provision of the 1981 model may be obsolete.

*Interest and royalties.*—The model allows no tax to be imposed by a treaty country on interest or royalty income derived and beneficially owned by a resident of the other treaty country.[45] By contrast, the OECD model would permit up to 10 percent gross-basis taxation of interest by the treaty country in which the interest arises.

The model defines interest as income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits. The recently signed, as yet unratified treaty with Germany may or may not signal a change in the preferred U.S. negotiating position on the issue of whether income from a debt-claim carrying a right to participate in profits constitutes interest. The 1989 German treaty provides that payments are not interest within the meaning of the treaty, and may be taxed in the source country under its internal laws, if the payments are deductible in determining the profit of the payor, and are made under arrangements, *including debt obligations*, carrying the right to participate in profits (arts. 10.5 and 11.2).

The model defines royalties as payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (not including cinematographic films or films or tapes used for radio or television broadcasting), any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience. The term also includes gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof.

The model prohibits imposing second level withholding tax on interest (that is, taxing interest paid by a resident of the other treaty country, which interest is not received by a person subject to tax in the first country either as a resident or as a nonresident subject to net basis tax) unless the interest arises in the taxing state and is not paid to a resident of the other treaty country. This provision is obsolete in light of the repeal of second level withholding tax on interest in the 1986 Act, and its replacement with the branch level interest tax (discussed above in Part II.D.3.). However, the model definition of where interest "arises" might be relevant in any future treaties that permit (presumably, contrary to what is thought to be Treasury's currently preferred negotiating position) imposition of a branch level interest tax. For this purpose, the model treats interest as arising either in the payor's residence country, or the country in which the payor has a permanent estab-

[44] *See, e.g.,* Articles IV and VIII of the 1988 U.S.-France income tax protocol, and the as yet unratified 1989 German and Indian treaties.

[45] As is true for dividends, this limitation does not apply to interest or royalties attributable to a source country permanent establishment through which a resident of the other treaty country carries on business, or to income attributable to a fixed base from which a resident of the other treaty country performs independent services. In the case of such income, it would be subject to the ordinary net-basis taxation rules applicable to any other income attributable to the permanent establishment or fixed base.

lishment or fixed base if the indebtedness on which the interest is paid was incurred in connection with, and the interest is borne by, that permanent establishment or fixed base.

*Real property.*—The model allows taxation by a treaty country of income derived by a resident of the other country from real property (including agriculture or forestry) situated in the first country (the situs country), but requires that the taxpayer be entitled to elect taxation on a net basis. The model also permits situs country taxation of gains from alienation of real property, including gains from alienation of stock in companies the property of which consists principally of real property situated in that country, and gains from alienation of interests in partnerships, trusts, or estates to the extent attributable to real property situated in that country.

*Other gains.*—Except as provided above, the model allows no tax to be imposed by a treaty country on gains from the alienation of personal property by a resident of the other treaty country.[46]

*Insurance excise tax.*—Reduction of income tax under the model applies to the excise taxes imposed on insurance premiums paid to foreign insurers, but only to the extent that the risks covered by such premiums are not reinsured with a person not entitled to the benefits of a U.S. treaty that applies to these taxes.

*Shipping and air transport.*—The model provides that profits of an enterprise of a treaty country from the operation of ships or aircraft in international traffic shall be taxable only in that country.

*Other income.*—The model provides that items of income, wherever arising, that are not dealt with in the articles of the treaty are taxable only by the recipient's country of residence.

*Limitation on benefits.*—The preferred U.S. negotiating position includes provisions designed so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the model by its terms generally benefits only residents of the treaty countries,[47] residents of third countries at times attempt to use a treaty. Such use is known as "treaty shopping," and refers to the situation where a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of U.S. tax by lending money, for example, to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. Under certain circumstances, and without appropriate safeguards, the nonresident is able indirectly to secure these benefits by establishing a corporation (or other entity) in one of the countries which entity, as a resident of that country, is entitled to the

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[46] As is true for dividends, interest, and royalties, this limitation does not apply to gains attributable to a source country permanent establishment through which a resident of the other treaty country carries on business, or gains attributable to a fixed base from which a resident of the other treaty country performs independent services. In the case of such gains, they would be subject to the ordinary net-basis taxation rules applicable to any other income attributable to the permanent establishment or fixed base.

[47] For some purposes, the treatment of citizens of either country is also affected, but generally this refinement is of secondary importance with respect to the effects of treaties on U.S.-bound investment by foreign persons.

benefits of the treaty. Additionally, it may be possible for the third country resident to reduce the income base of the treaty country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions (i.e., it may be possible to reduce or eliminate taxes of the resident company by distributing its earnings through deductible payments or by avoiding withholding taxes on the distributions) either though relaxed tax provisions in the resident country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

If the United States unilaterally wished to reduce taxes on inbound investment to the rates in the treaty, treaty shopping probably would not be an issue (indeed, the reduced rates could be enacted into the Code). However, the treaty negotiation process is a means for obtaining concessions of foreign tax rules otherwise applicable to U.S. persons with income abroad. In addition, for other reasons the treaty provisions appropriate to the U.S. tax treatment of residents of one country may be viewed as inappropriate to the treatment of residents of some others. Consequently, the 1981 model contains an anti-treaty shopping, or "limitation of benefits" article, and the Treasury has subsequently appeared to refine the 1981 approach in its negotiating positions.[48]

The 1981 model provides that a person other than an individual (such as a corporation, partnership, or trust), that is resident in one treaty country (the residence country), is not entitled to treaty relief from taxation by the other country (the source country) unless it satisfies at least one of two tests: an ownership and "base erosion" test and a good business purpose test. Finally, the model provides that any treaty relief from tax shall be inapplicable to the extent that, under the internal law of the residence country of the income recipient, the income to which the relief relates bears significantly lower tax than similar income arising within the residence country derived by residents of that country.

Under the ownership and base erosion test, two conditions must be satisfied. First, more than 75 percent of the beneficial interest in the entity seeking the treaty relief must be owned, directly or indirectly, by one or more individual residents of the entity's residence country. The model states that a company that has substantial trading in its stock on a recognized exchange in a treaty country is presumed to be owned by individual residents of that country. Second, the income of the entity may not be used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons other than residents of either the source country or the entity's residence country, or U.S. citizens. This rule is commonly referred to as the "base erosion" rule and is necessary to prevent a corporation, for example, from distributing most of its income through the use of deductible payments to persons not entitled to benefits under the treaty.

The good business purpose test is satisfied if it is determined that the acquisition or maintenance of the entity and the conduct of its

[48] The OECD model contains no such limitation of benefits article, although the commentary indicates that such provisions may be appropriate.

operations did not have as a principal purpose obtaining benefits under the treaty.

Refinements to the 1981 model may be said to be reflected in a Treasury discussion draft and a number of treaty provisions that have since been negotiated or ratified, and in the qualified resident definition under the branch tax provisions of the Code (see discussion in Part II.D.3. above). Under the Code, the 1989 German treaty (as yet unratified), the 1988 Belgian and French protocols, the 1988 Indonesia treaty (as yet unratified), the 1986 China protocol, and the 1984 Barbados treaty, for example, an entity is entitled to treaty benefits if it meets one of *three* tests: ownership and base erosion, good business purpose, *or* public company. Meeting the public company test is typically similar to meeting the ownership test under the 1981 model by virtue of the entity's stock being traded on a recognized treaty country exchange. The ownership test may often be satisfied if the entity is beneficially owned, over a threshold percentage, by a combination of U.S. citizens or residents, or residents of the other country. Meeting the good business purpose test under some of these recent provisions may require (absent approval by the source country competent authority) being engaged in the active conduct of a trade or business in the entity's residence country (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company), and having the income derived from the source country be derived in connection with, or be incidental to, that trade or business (e.g., German treaty, art. 28.1(c)).

*Nondiscrimination.*—In a departure from the scope of other provisions of the model, the model nondiscrimination clause imposes restrictions not only on foreign country taxation and U.S. Federal income taxation, but also on gift and estate tax and on all other nationally imposed taxes "of every kind and description," as well as on all taxes imposed by any state or other political subdivision or local authority thereof. The model provides that nationals of a treaty country, wherever they may reside, shall not be subjected in the other country to any taxation (or any requirement connected therewith) which is other or more burdensome than the taxation and connected requirements to which nationals of that other country in the same circumstances are or may be subjected. Similarly, the taxation on a permanent establishment which an enterprise of a treaty country resident has in the other country (the source country) generally shall not be less favorably levied in the source country than the taxation levied on enterprises of source country residents carrying on the same activities. Thus, for example, the U.S. branch of a treaty country bank would generally be entitled to U.S. tax parity with a U.S. bank. Further, an enterprise of a source country resident, the capital of which is wholly or partly owned or controlled by residents of the other country, shall not be subjected in the source country to any taxation (or any requirement connected therewith) which is other or more burdensome than the taxation and connected requirements to which other similar source country enterprises are or may be subjected. Thus, a U.S. corporation wholly owned by a treaty country resident, for example, would generally be entitled to tax parity with similarly situated U.S. corporations wholly owned by U.S. persons. Finally, the model generally provides (subject to certain arm's length standards) that interest, royalties, and other disbursements paid by a treaty country resident to a resident of the other country shall, for the purposes of determining the taxable profits of the payor, be deductible under the same conditions as if they had been paid to a resident of the source country.

*Mutual agreement procedures.*—The model provides for a treaty country resident or national to obtain relief, from the competent authority of his home country, from actions of either or both countries that are considered to result in taxation in violation of the treaty. The model requires the competent authorities to endeavor to resolve such a case by mutual agreement where the home country authority cannot do so unilaterally.

*Exchange of information and administrative assistance.*—The model provides that the competent authorities of the treaty countries shall exchange such information as is necessary for carrying out treaty provisions and the internal tax laws of each country. When appropriate materials, including depositions of witnesses and authenticated copies of unedited original documents, are requested by one competent authority, the model requires the other competent authority to obtain those materials to the same extent that it could do so if the materials related to taxes of the other state. Moreover, under the model each country agrees to endeavor to collect, on behalf of the other, amounts necessary to ensure that treaty relief from the second country's tax does not inure to the benefit of persons not entitled to that relief.

*Associated enterprises.*—The model permits each country to alter the distribution of profits among members of a controlled group of entities in order to reflect the conditions that would be made between independent enterprises, and to deny treaty benefits for interest and royalties passing between such members in excess of amounts that would have passed between independent entities. The model expressly permits application of internal law provisions which permit the distribution, apportionment, or allocation by the government of income, deductions, credits, or allowances between persons, whether or not residents of a treaty country, owned or controlled directly or indirectly by the same interests, when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons. This language tracks that of Code section 482 as in effect prior to the 1986 Act.

### *Treasury's model transfer tax treaty*

The 1980 U.S. model estate, gift, and generation-skipping transfer tax treaty contains one provision of particular significance with respect to inbound investment. Under the model treaty, only U.S. real property and U.S. business property is included in the gross estate of a foreign decedent. The model treaty does not contain a provision found in certain older U.S. estate tax treaties (e.g., the 1955 Italy treaty) that allows as a basic credit in determining estate tax the percentage of the basic credit available to U.S. decedents in proportion to the amount of the worldwide gross estate that consists of property located in the United States.

### *Departures from the model*

Of the income tax treaties currently in effect, many diverge in one or more respects from the 1981 model. These divergences may reflect the age of a particular treaty or the particular balance of interests (bearing on outbound as well as inbound investment) between the United States and the treaty partner.

Other countries' preferred tax treaty policies may differ from those of the United States depending on their internal tax laws and depending upon the balance of investment and trade flows between those countries and their potential treaty partners. For example, where the United States has sought to negotiate treaties that waive all source country tax on interest, royalties, and personal property rents paid to residents of the other treaty country, certain capital importing countries may be interested in imposing relatively high source country tax on such income. Consequently, treaties with such countries may have higher dividend withholding rates, and non-zero interest, royalty, or personal property rental rates (see, e.g., the as yet unratified treaties with Indonesia and India), or may permit a building site, or construction or installation project, or mineral resources extraction site, to constitute a permanent establishment although lasting 12 months or less. Or, the other country may demand other concessions in exchange for agreeing to U.S. terms.[49]

As other examples, the United States has so far been unable to obtain the currently preferred limitation of benefits provisions in treaties with the Netherlands and the Netherlands Antilles. In addition, the insurance excise tax waiver in the U.K. treaty has no anti-conduit clause. The United States has also been unable to obtain the preferred type of nondiscrimination clause with Canada, and until recently was unable to secure the benefit of imputation credits for German corporation dividends to U.S. shareholders. In some cases, as with the Netherlands Antilles, the inability to obtain the desired provision may lead to termination (or near-termination) of the income tax treaty relationship between the United States and that country. In other cases, as with the Netherlands, U.K., Canada, and Germany, the relationship has continued, while periodic negotiations have also continued.

Another type of departure from the model may occur because of internal tax laws (or the lack thereof) peculiar to the treaty country. Thus, the United States generally has not entered into tax treaties for the purpose of reducing U.S. source country tax on residents of countries that would impose no tax on the same income. However, if a treaty country, the internal laws of which are not otherwise unusual, gives special tax reductions in particular areas,

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[49] For example, in cases where a country taxes certain local business operations at a relatively low rate, or a zero rate of income tax (whether to attract manufacturing capital to that country or for other reasons), that country may seek to enter into "tax-sparing" treaties with capital exporting countries. That is, the first country may seek to enter into treaties under which the capital exporting country gives up its tax on the income of its residents derived from sources in the first country, regardless of the extent to which the source country has imposed tax with respect to that income. For a statement of some of the policies implicated by tax sparing, see, e.g., *Double Taxation Convention with Pakistan: Hearing before the Senate Comm. on Foreign Relations*, 85th Cong., 1st Sess. 1-34 (1957) (testimony of Professor Stanley Surrey). The United States has rejected proposals by certain foreign countries to enter into such tax sparing arrangements.

or if the United States believes that other reasons justify a tax treaty relationship with a country imposing little or no income tax on foreign income of domestic persons (or even a country imposing little or no income tax on domestic income, in some cases), treaties may be entered into that lack one or more of the ordinary, source-country tax-reducing provisions of the model.[50]

[50] See, e.g., the Bermuda treaty and the 1988 statutory provision (section 6139 of the 1988 Act) addressing the status of the insurance premium excise tax clause in the Barbados treaty. *See also* Exec. Rep. 100-23, 100th Cong, 2d Sess. 4 (1988) ("the [Foreign Relations] Committee believes the insurance excise tax provision should not have been entered into between the United States and Barbados. Accordingly, it has asked for and has received firm commitments from the Treasury and State Departments to renegotiate the Barbados treaty to eliminate its waiver of U.S. insurance excise tax by the earliest date permissible under the treaty, January 1, 1990.")

# III. ISSUES AND ANALYSES

## A. Macroeconomic Relations and Foreign Investment

Many macroeconomists view the net flow of investment into or out of the United States, the difference between the gross flow of investment by the United States abroad and the gross flow of foreign investment into the United States, as a potentially important determinant of aggregate economic activity. Changes in tax policy regarding foreign investment in the United States may affect the net flow of investment. In order to evaluate tax policy relating to foreign investment, it may be useful to consider the macroeconomic repercussions of any change.

### 1. Balance of payments

As discussed in Part I, the balance of payments accounts measure financial flows into and out of the United States. The current account balance, which consists primarily of the balance of trade in goods and services, is, by definition, exactly offset by the capital account balance. The capital account consists of the net flow of private investment into and out of the United States plus changes in the holdings by governments, central banks, and other official agencies. Thus, the recent U.S. trade deficits must be offset by net inflows of investment into the United States by foreign private investors, unless the United States or foreign governments are willing to finance the current account balance through purchase or sale of assets.

While the current account deficit and net capital inflows are closely related, it may not be accurate to infer that the trade deficit has caused the recent net inflow of investment. Indeed, some argue just the reverse—it is the high demand by foreign persons for U.S. assets that has led to the imbalance in capital flows, and the trade deficit is merely the consequence.

Standard textbook analysis emphasizes that the balance of trade between the United States and the rest of the world depends on the level of prices in the United States and abroad and the level of exchange rates.[51] A strong dollar, under this analysis, is associated with higher levels of U.S. imports relative to exports.

This simple analysis further states that the net demand for investment into or out of the United States depends on the relative level of interest rates abroad and in the United States (or more generally, the after-tax rates of return available on investments) and the expected appreciation or depreciation of the exchange rate. Thus, relatively high real interest rates (nominal interest rates less expected inflation) in the United States encourage the net flow of

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[51] See, for example, Rudiger Dornbusch and Stanley Fischer, *Macroeconomics*, McGraw-Hill, 1987. The effect of prices is intended to cover the quality and desirability of products as well.

investment into the United States. Expected changes in exchange rates are important because they determine the value of future returns on investment to the investor in his home country.

With flexible exchange rates, which have generally prevailed since 1973, and limited government intervention, this analysis predicts that the balance of trade and net investment flows are a result, and a determinant, of exchange rates and U.S. interest rates. It is the interaction of the relative demand for and supply of foreign currency and the dollar, based on the net demands for exports and imports and the net demands for investments in the United States and abroad, that determines exchange rates. In addition, since foreign investment in the United States may affect the level of savings and investment in the United States (see Part III.A.2), interest rates are also affected by certain of these same factors. Thus, exchange rates and interest rates are simultaneously determined.

Some have emphasized that high U.S. interest rates have induced a net inflow of capital into the United States. The demand for U.S. dollar denominated assets, it is argued, raised the exchange rate and the trade deficit has been the result as U.S. exports became less competitive in the world market. Others argue that strong exchange rates and declining U.S. export competitiveness have led to the trade deficit. In order to finance these deficits, it follows that relatively high U.S. real interest rates have been necessary to induce a corresponding inflow of foreign capital.

Regardless of the cause of the present international situation, it is widely believed that major tax policy changes relating to foreign investment in the United States may have a macroeconomic impact. For example, tax policy designed to encourage foreign investment in the United States may exacerbate contemporaneous trade deficits. This might occur because the demand for U.S. dollar denominated assets would cause an appreciation of the dollar, thus increasing net imports. The increased investment funds in the United States might, however, reduce interest rates.[52] Conversely, tax policy that discourages foreign investment in the United States may reduce the size of the United States trade deficit but might increase real interest rates.

The textbook model is clearly an oversimplification for certain purposes. The gross amount of cross-border investment is much greater than the net investment flow. This suggests that the reasons for investment, particularly direct investment, may be less dependent on relative after-tax risk-adjusted rates of return than on other more idiosyncratic reasons, such as a need to operate more closely to final consumers or avoid import restrictions. If this is true, the effect of changes in tax policy on investment in the United States may be smaller than some believe, and the corresponding macroeconomic impact may be small. On the other hand, if the gross flows are sensitive to changes in tax policy, the macroeconomic impacts of such changes may be larger than one would conclude by looking solely at the size of the net flows.

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[52] This example assumes that the tax change does not increase the budget deficit. An increased budget deficit might offset the inflow of investment and raise interest rates.

**2. Saving and investment**

Many macroeconomists also consider the net flow of investment into or out of the United States as potentially important for determining the aggregate level of domestic investment. By accounting definitions, gross private domestic investment is equal to gross private savings (the savings of U.S. individuals plus the savings by U.S. business), minus the combined net budget deficits of Federal, State and local governments, plus net foreign investment. Thus, net foreign investment represents a source, besides that of domestic savings, for investment in the United States.

Many people have expressed concern about the relatively low level of investment in the United States. In particular, the measured private savings rate in the United States is low relative to most other industrial nations. This fact, combined with the recent large Federal budget deficits, leads many to express concern about the availability of funds for investment. In 1988, net foreign investment into the United States was equal to 15.6 percent of gross private domestic investment, or 3.6 percent of gross national product.[53]

Tax policy changes that significantly affect the level of foreign investment in the United States may affect the level of gross private domestic investment. A change in the demand for investment in the United States by foreign persons, which may have been induced by tax policy, will affect the equilibrium level of aggregate savings and investment. The change in foreign investment, however, should not be viewed in isolation from other effects on investment. For example, an increase in tax on foreign investment in the United States that discourages such investment might still increase total U.S. investment if the budget deficit were sufficiently reduced or private savings were otherwise increased. Since real interest rates are the "price" that serve to equate the actual level of savings and investment in the economy, any policy change that affects the supply of savings or demand for investment is likely to affect interest rates as well.

Some argue that foreign investment increases the size of the capital stock in the United States and, thus, may increase U.S. productivity and output. Others emphasize that foreign investment in the United States represents a claim on future U.S. resources. For example, purchase of U.S. bonds by foreign persons obligates the payment of interest and principal in the future. Increased levels of foreign investment in the United States, therefore, will require an increasing share of output in the future to be transferred abroad. At some point in the future, the United States trade balance must be in surplus, in order to service the future payments of interest and dividends on foreign investments in the United States. Thus, the recent current account deficits and the corresponding inflow of foreign capital into the United States will tend to induce trade surpluses in future periods. It is possible, however, that these future periods may be remote.

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[53] "National Income and Product Account Tables," *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, July, 1989, tables 1.1 and 5.1.

The benefit to the United States economy of net foreign capital inflows is often judged by whether the inflow increases investment that will yield increases in domestic output in the future that exceed the return remitted to the foreign person on the investment. Proponents of foreign investment argue that such investment will increase the U.S. capital stock and U.S. productivity and generate net benefits to the economy. On the other hand, if foreign investment displaces domestic investment, the net effect of foreign investment would be to raise current levels of domestic consumption. In this case, the United States would, in the future, need to service and make repayments on the foreign investment without any concomitant increase in national income to make such payments. Thus, future income available to Americans would fall.

As an historical example, during all of the nineteenth century the United States was a net debtor nation to the rest of the world; the United States did not become a net creditor until after 1910.[54] In 1853, for example, 20 percent of U.S. debt and equities were owned by foreign persons. Many economic historians argue that this foreign capital was profitably used to finance the expansion and industrialization of the United States. In particular, foreign capital was widely used for the construction of canals and railroads at a time when the domestic capital market was somewhat undeveloped. To the extent that the return to the domestic economy from the foreign investment exceeded the payments, this capital inflow can be credited for assisting in the rapid industrialization of the United States in the nineteenth century.

Another example is provided by the present "third world" debt crisis. Many developing countries borrowed heavily from abroad during the 1970s. Some argue that the capital from abroad was generally not profitably invested, but rather served to increase current consumption or was invested in low-return projects. Thus, as repayments became due the productive capacity necessary to fund the obligations was not available, and crippling impacts on these economies ensured.

### B. Theory of International Taxation

The economic theory analyzing the optimal taxation of international investment flows is complex, sometimes contradictory, and often incomplete. Few results are universally accepted, but certain basic themes do emerge. One limitation to the analysis is that the appropriate *total level* of tax on income from assets located in a country different than the residence of the owner often is identified, as opposed to the appropriate *division* of tax between countries where assets are located and countries in which the owners of assets reside, which often is not determined. Much of the analysis has been in terms of the appropriate taxation of assets invested abroad by a country that exports capital. The analyses do provide, however, certain insights into the factors that affect the appropriate taxation of inbound investment from abroad.[55]

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[54] James Jackson and William Jackson, *Foreign Ownership of U.S. Assets: Past, Present and Prospects*, Congressional Research Service Report No. 89-458 E, July 1, 1989.

[55] Daniel Frisch, "The Economics of International Tax Policy: Some Old and New Approaches," unpublished manuscript, 1989, provides a useful non-technical discussion of many of these issues.

*Worldwide versus national treatment*

One of the most fundamental issues in the analysis of the optimal taxation of international investment is the difference between what is best for a particular country and what is best when evaluated for the whole world. From the worldwide perspective, a good tax system may be one that does not distort the allocation of capital between countries and types of investment. From a single country's perspective, a good tax system may be one that maximizes the income available to its residents, which would include the tax revenue the government is able to raise from foreign persons.

The two criteria are often in conflict concerning the proper tax outcome. For example, if the amount of inbound investment is relatively insensitive to the tax rate, it may be to the source country's advantage to impose a relatively high rate of tax on income from that capital. From a worldwide perspective, however, too little capital may be allocated to that country. Such a country will have extracted tax revenue at the expense of worldwide economic efficiency.

*Alternative principles for international tax regimes*

*In general*

One possible goal for an international tax regime is the maximization of worldwide income. If the tax system of each country is neutral with respect to its investors' allocation of capital among all countries, many would argue that this goal is achieved.[56] Such a tax system is said to exhibit "capital export neutrality," and under such a system an investor's choice of where to invest is unaffected by tax considerations. Under capital export neutrality, income from assets invested domestically (the country of residence) is taxed at the same rate as income from assets that are invested abroad; the tax rate on an asset depends only on the residence of the owner and not the location of the asset. The principle, which is often justified by a global perspective, only establishes the total tax burden and not how the tax revenue should be allocated between the source country and the country of residence.

As an alternative, the principle of capital *import* neutrality asserts that income from capital should be taxed on the basis of where it is invested, regardless of the residence of the investor. Again, this principle does not determine to whom the tax should be paid. Under one regime that achieves capital import neutrality, for example, every country would tax the income on capital invested within its borders regardless of the source of that capital, and the country of residence (the country in which the investor resides) would not tax the income.[57] Capital import and capital export neutrality can occur together only when the tax rates on capital income are the same in all countries.

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[56] See, for example, the discussion in Richard Caves, *Multinational Enterprise and Economic Analysis*, 1982, ch. 8.

[57] Thomas Horst, "A Note on the Optimal Taxation of International Investment Income," *Quarterly Journal of Economics*, June 1980, pp. 793-798, describes conditions under which this may be optimal.

Capital import neutrality is often espoused by private U.S. interests as it would imply that the United States should exempt from tax income earned abroad. They argue that capital import neutrality is in the best interest of the United States as it would enable U.S. business to compete more effectively abroad against companies operating in countries with relatively low rates of tax. This proposal has the effect, unlike capital export neutrality, of encouraging investment to be made abroad instead of domestically where the foreign tax rate is less than the domestic rate. It is argued that encouraging U.S.-owned capital to move to low tax rate countries would provide more benefits to the United States than domestic investment of the same capital. For example, this concept underlies the possessions tax credit (sec. 936) and bilateral "tax sparing" agreements that have been entered into between certain countries.

A third principle asserts that the tax system should favor domestic over foreign investment. This "pro-national" principle would impose a higher rate of tax on income earned from abroad than at home, and a higher rate than would occur under either capital import or capital export neutrality. For example, the present laws of some countries, including the United States, provide a credit against domestic tax equal to the tax paid to the source country, and thus the residence country forgoes some tax revenue on income from capital invested abroad. Under one pro-national approach, no foreign tax credit would be given for foreign taxes paid, and instead only a deduction would be provided. Because under a credit system the residence country does not collect some or all of the tax imposed on investment abroad, it might be argued that national welfare will be increased by collecting more tax on such income and encouraging domestic investment. Unlike capital export neutrality, this approach is expressly intended to distort the decision on whether to invest at home or abroad.

### *The United States tax system*

Many say that the U.S. tax system, for the most part, follows the principle of capital export neutrality in taxing capital owned by its residents.[58] Two major exceptions are the deferral of tax generally provided to active business income earned abroad by U.S.-owned foreign corporations and the limitation that no credit is provided for foreign taxes paid that, on average, exceed the U.S. tax rate. Both exceptions move the system more toward one exhibiting capital import neutrality. Deferral of tax on active foreign business income is, to some degree, economically equivalent to an exemption if the period of deferral is sufficiently long. The limitation that the average rate of credit (within categories of income) may not exceed the U.S. tax rate implies that the source country's rate of tax will apply, as capital import neutrality dictates, for cases in which the source country's rate is higher than the U.S. rate. The credit limitation may not be binding, however, since a taxpayer may be able to cross-credit foreign taxes paid in high tax rate countries against certain income subject to low source country tax rates.

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[58] See, for example, *The President's Tax Proposals to the Congress for Fairness, Simplicity, and Economic Growth*, 1985, p. 383.

Finally, certain aspects of the U.S. tax system have features of a pro-national nature. For example, many tax preferences, such as accelerated depreciation, are not available for property used predominantly outside the United States.

*Coordination of the taxation of foreign investment*

The analyses that emphasize that the international tax system should promote worldwide welfare provide only limited guidance as to whom tax should be paid. For example, capital export neutrality may hold if every source country (the country in which the capital is invested) exempts foreign persons from tax while the residence country imposes tax on income at home and abroad at the same rate. Alternatively, a system in which the source country and residence country both impose tax, but in which the residence country provides a credit equal to the source country's tax, is also capital export neutral. In terms of the tax revenue received by each nation's fisc, however, the results may be very different. All other things being equal, a net debtor nation prefers a system in which the source country obtains as much of the revenue as possible, while a net creditor nation prefers a system in which the source country exempts income derived in that country.

The international tax system, for the most part, has evolved into one in which the source country imposes tax and the residence country either provides a credit against residence country tax or else exempts the income from residence country taxation. This system, on a global scale, generally displays properties that lie between capital export and capital import neutrality.

Under the credit system, there may be an incentive for both capital importing and exporting nations to deviate on the margin from neutrality. For example, capital exporting nations prefer that investment be placed in countries with relatively low tax rates, so as to limit the amount of tax that must be credited. Thus, most countries place limits on the amount of tax that can be credited against the home country's tax. Specifically, they typically limit the average rate of foreign tax credit (over some base) to the rate of residence country tax due on that income.

Capital importing nations have the incentive to extract as much revenue as possible without materially affecting the benefit they otherwise receive from foreign investment placed in their country. To the extent that the residence country is willing to credit a tax, the source country always has an incentive to impose one. Such a tax is a pure transfer from the residence country's fisc to the source country's. A number of aspects of the U.S. system are designed to prevent schemes for accomplishing such transfers.[59]

Administrative difficulty in applying the necessary limitations on foreign tax credits is one justification used to argue for an exemption of income earned abroad, or a minimum tax, not reducible by credits, on foreign source income. Countries using the exemp-

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[59] *See, e.g.*, Treas. Reg. sec. 1.901-2(c) (denying credits for so-called "soak-up taxes," or taxes the liability for which is dependent on the availability of a U.S. credit); Code sec. 901(i) (denying credits for taxes used to provide subsidies); sec. 904(d)(1)(B) and (2)(B) (providing a separate foreign tax credit limitation on high withholding tax interest).

tion system may require full current taxation of income earned in some low rate countries, to avoid exploitation by these countries.

A nation may also have the incentive to impose a tax, even though not credited in the residence country, if the amount of foreign investment in that country is relatively insensitive to the tax levied. In this way, the source country is able to appropriate some of the income that, in the absence of the tax, would be transferred abroad. Although this policy may increase such nation's welfare, it comes at the expense of other nations, and in some cases, worldwide welfare as a whole. The larger, industrialized countries are the ones most likely to have sufficient market power to obtain an advantage from following this type of policy. A "beggar thy neighbor" policy, if adopted by all countries, may leave all countries worse off than they would have been if the additional tax on income from foreign-owned capital had not been imposed.[60]

A completely different strategy, typically used by small countries with little market power, is to provide tax exemption or tax holidays, often in coordinaton with tax sparing agreements, for capital invested from abroad. Supporters of this approach argue that small changes in tax rates will be sufficient to induce a large reallocation of capital toward the country offering the inducements. The benefit of the capital flow, it is argued, will exceed the costs of any foregone revenue. The strategy is exactly parallel to competition between States in the United States offering tax holidays, etc. for large new projects. Just as in the case of the States, while the tax inducement strategy may be beneficial to some country when it is the sole practitioner, widespread adoption of such a policy would leave all nations worse off.

These examples demonstrate the potential desirability for some type of international coordination in tax policy. Source country taxation with some degree of credit by the residence country is one form of coordination. Tax treaties are another. Most industrialized countries in their tax treaties agree to a policy of nondiscrimination in the taxation of investment from abroad. Nondiscrimination generally means that the source country will not impose tax that is more burdensome than is imposed on domestic investors. Moreover, tax treaties often reciprocally reduce the rates of withholding tax on income on investment from abroad, although the different incentives of capital-importing and capital-exporting nations often make these negotiations problematic. Finally, international norms, as well as tax treaties, attempt to divide taxing jurisdictions so that income may be subject to tax in some jurisdiction but some type of relief is provided when more than one country asserts jurisdiction.

In summary, individual nations often have an incentive to extract tax revenue in a manner that, if adopted universally, may reduce worldwide income. In particular, national income may be increased by imposing tax on investment from abroad that exceeds the level that maximizes worldwide income. This incentive may be particularly relevant for large countries, like the United States, be-

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[60] This policy is exactly parallel to "beggar thy neighbor" tariff policies. If a capital-importing nation is "small," the nationally optimal rate of tax may never exceed the rate at which a residence country is willing to credit such tax. See Joel Slemrod, "Effect of Taxation with International Capital Mobility," in Henry Aaron, Harvey Galper, and Joseph Pechman, eds., *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax*, The Brookings Institution, 1988.

cause of the "market power" in the market for capital that size may provide. In addition, net debtor countries may have a greater incentive to impose a high rate of tax on income from investment from abroad, because the threat from retaliation in kind is low and the revenue gained obtained is large. Finally, a country has the incentive to tax income from investment from abroad to the extent that this tax will be credited in the residence country.

*Extensions and limitations*

The economic theory of international taxation can be extended in a variety of directions that encompass a broader range of behavior but also demonstrate some of the limitations of the theory. For example, much theorizing about international capital flows assumes that all flows are either inbound or outbound. In fact, the level of gross cross-border investment is greatly in excess of the net investment position for most of the major industrialized countries, including the United States. The incentives to behave like a capital exporting nation and a capital importing nation exist simultaneously. The balance of these incentives, however, may depend on the net investment position of the country.

The distinction between direct and portfolio investment is often glossed over in the analyses of international tax systems. As the motivations for both types of investment may be different, their responses to the tax system may be as well. Investment is typically assumed to be portfolio in nature. Portfolio investment, while perhaps less complex than direct investment, may be much more complex than the models allow. There is a substantial amount of cross-border lending in a variety of debt and equity instruments that do not neatly fall within the bounds of most models. The practical details of the international tax system as applied to financial intermediation may be too subtle for any simple analysis.

The analyses of direct investment by multinational enterprises emphasize the role that firm-specific factors play in investment decisions. Methods for the firm to exploit markets, achieve economies of scale and scope, and avoid trade and investment restrictions affect the investment decisions of multinationals, it is argued, more than macroeconomic considerations of relative market returns on investments. Thus, direct investment may be relatively insensitive to macroeconomic factors that affect portfolio investment and may respond to tax policy changes in different ways.

Some argue that the role of the multinational enterprise may provide room for "strategic" tax policy regarding inbound investment, in a manner analogous to the arguments sometimes provided for strategic trade protection. For example, in certain new industries there may eventually be room only for a small number of very large companies globally. It may be in the best interest of a country, therefore, to discourage the expansion of other countries' multinationals for the benefit of the country's own businesses. High rates of tax on inbound direct investment could be used to promote U.S. industry, but other types of protectionist policies may be equally efficacious.

Detractors point out that this type of protectionist tax policy is open to nearly all of the same criticisms as protectionist trade policy. They argue that the benefits of this type of policy have never been established to be important in practice, and that the politics of protection are likely to deviate substantially from what a purely theoretical "optimal" strategic tax policy would suggest.

### C. United States International Investment Position and Tax Policy

Perhaps the most significant trend affecting U.S. tax policy regarding investment by foreign persons is the shift of the United States from net international creditor to debtor. The large net inflows of foreign capital into the United States has likely already made, or soon will make, the United States host to a greater level of foreign-owned assets than U.S. investors hold abroad. Thus, some contend that the experience of the United States as a net international creditor, which had held true for decades and shaped U.S. tax policy toward international investment, may no longer be relevant. Since the United States is likely to be a net debtor for the foreseeable future, it is argued, U.S. tax policy ought to respond to the changed conditions.

Capital-importing nations and capital-exporting nations often have conflicting desires concerning the distribution of tax revenue. Capital-importing nations generally desire tax to be collected at source while capital-exporting nations typically prefer tax to be collected by the country of residence.[61] United States tax policy, as expressed in tax treaty policy, for example, reflects its history as a capital exporter. Many argue that U.S. tax policy should respond to its new status by placing more emphasis on taxation at source. This new policy might call for higher withholding rates in treaties and, perhaps, the imposition of tax on portfolio and bank deposit interest.

Supporters of existing policy argue that any shift from present policy would be shortsighted and misguided. They maintain that increased levels of tax on such capital would reduce much needed foreign investment in the United States. In addition, the increasing internationalization of business and financial markets preclude the desirability of imposing higher levels of source taxation. Such taxation would, they contend, reduce the efficiency gains that expanded global trade and investment provides. Moreover, the United States at some point in the future once again may become a net international creditor. Stable, long-term tax policy, they contend, should not be reversed as a result of temporary fluctuations in economic circumstances.

### D. Foreign Direct Investment in the United States

#### *Benefits of direct investment*

Apart from the general benefits that may be obtained from foreign investment in the United States which were identified in Part III.A, some have argued that direct investment specifically provides

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[61] Tax havens, typically small island nations, attract financial capital by offering tax exemptions. Often by assisting in the avoidance or evasion of tax imposed by other countries, tax havens are able to develop disproportionately large financial sectors. The benefits of the financial sector may be sufficiently large relative to the small size of the economy to justify the tax exemption.

benefits to the United States.[62] The first advantage that direct investment may provide is a result of the increased integration of the global economy. Direct investment may permit a more efficient allocation of resources and permit greater specialization of production by specific companies. In addition, increased integration may provide greater competition and thus reduce the exercise of monopoly power in the United States.

Another potential advantage of direct investment is the transfer of technology and know-how that may occur. If direct investment brings with it technology, managerial methods, or additional job training that has external benefits beyond the investing company, the United States as a whole may benefit.

*Costs of direct investment*

Much attention has been placed on the disadvantages of direct investment. In particular, the focus has been on the effect that direct investment has had on U.S. employment and income. The basic assumption of many opponents of direct investment is that direct investment from abroad reduces U.S. output and increases imports. By substituting imports for U.S. goods or services, direct investment reduces U.S. employment, according to their argument.

The counterargument points out that aggregate employment is determined by macroeconomic conditions. Although employment in certain industries and geographic locations may be adversely affected by direct investment, the overall level will be essentially unchanged. Instead, if direct investment in the United States increases imports, that increase would primarily affect the exchange rate. A weaker dollar, resulting from the increased demand for imports, would have the net effect of raising the cost of obtaining goods from abroad.

The data on non-bank U.S. affiliates of foreign businesses show that imports by these affiliates exceeded exports by $92 billion in 1987, or 57 percent of the trade deficit.[63] These statistics may be misleading as over $60 billion of the excess occured in affiliates in the wholesale trade industry. These wholesale trade companies typically are nothing more than the marketing agents in the United States for the foreign businesses.

Opponents of direct investment in the United States have some empirical support for the argument that direct investment does increase imports.[64] Ironically, these studies were based on U.S. direct investment abroad and claimed to show the positive effect of U.S. direct investment on U.S. exports. To the extent these results are valid, proponents of direct investment contend that the effect may not be so much on the level of imports as on the resulting exchange rate.

Another argument leveled against direct investment is that parochialinterests of the foreign parent cause good jobs and valuable economic activities of the multinational firm to be retained in the home country rather than allocated efficiently among the firm's af-

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[62] Much of the discussion of benefits and costs is drawn from Helpman and Krugman, 1989, ch. 3.

[63] Howenstine, 1989, p. 17.

[64] Fred Bergsten, Thomas Horst, and Theodore Moran, *American Multinationals and American Interests*, The Brookings Institution, 1978.

filiates. Thus, the benefits to the countries hosting the operations may be small or nonexistent.

A final concern which has influenced trade policy is the effect that foreign direct ownership may have on national security. This concern can be expressed in a variety of ways: U.S. affiliates may transfer technology or secrets from the United States; foreign-owned firms may be unreliable suppliers for military or other vital products; and foreign acquisitions remove from U.S. control companies crucial to the domestic industrial base.

*Tax policy and direct investment*

Direct investment in the United States, when undertaken through a U.S. corporation, is generally subject to two levels of tax. The first level of tax is the corporate income tax that applies to all U.S. corporations. The second (or investor) level tax is a 30 percent withholding tax imposed on interest and dividend payments to the foreign investor. The withholding tax rates are typically reduced by treaty. The 1986 Act made the treatment of U.S. branches of foreign corporations, which were already taxed on their U.S. effectively connected net income, roughly equivalent to the treatment of U.S. subsidiaries through the imposition of the branch taxes.

Arguments concerning the appropriate level of tax that ought to be imposed on direct investment in the United States are collateral to the arguments regarding the tax burden that ought to be imposed overall on inbound investment. For some of the reasons presented above, however, opponents of direct investment argue that tax policy should be used to discourage direct investment in the United States relative to portfolio investment; proponents argue just the reverse. Tax policy based on concepts of investment neutrality, however, have often been the stated goal of U.S. policy.[65] The proper interpretation of tax neutrality with respect to foreign investment is a subject of some dispute.

*Net income taxation*

***In general***

Income of a U.S. corporation with a foreign owner generally is subject to income tax at the corporate level in the same manner as income of a corporation owned by a similarly situated U.S. person. The net U.S. effectively connected income of a foreign corporation is likewise subject to income tax at corporate rates.[66] The United States thus follows the internationally accepted practice of taxing business income earned in the United States without regard to the owner of such investment.[67] Given that U.S. corporate tax rates are low relative to other industrialized nations, this practice may yield no more than a capital export neutral tax as long as the country of residence provides an exemption or a foreign tax credit for U.S. tax paid. Instead, this practice retains for the U.S. fisc an internationally accepted share of tax revenue. Any reduction in the

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[65] *General Explanation of the Tax Reform Act of 1986*, Staff of the Joint Committee on Taxation, (JCS-10-87), May 4, 1987, p. 10.

[66] Effectively connected income of nonresident individuals is taxed at the individual rates.

[67] Certain countries provide tax holidays and concessions to foreign investors in some industries or projects.

net income tax, unless negotiated by treaty, would not likely be reciprocated by other major nations.

*Transfer pricing*

The problem of determining accurate transfer prices between related parties is a major obstacle to the proper measurement of net income within any jurisdiction. Business enterprises operating in multiple jurisdictions may set transfer prices among the affiliates in a way to reduce total taxation. Of concern for the U.S. fisc is the ability to reduce U.S. tax payments below the amounts properly due.

For example, assume a multinational enterprise manufactures a product in its residence country, and transfers the product to a foreign marketing affiliate which then sells the product to consumers. If the first country imposes tax at a higher rate than the affiliate's residence country, and the first country also provides deferral or exemption for income earned abroad, then there is an incentive to establish an unreasonably low intercompany price for the product. A low intercompany price would cause income in the first country, which is subject to tax at a high rate, to be artificially low while the income in the affiliate's residence country would be artificially high. By manipulating transfer prices, total tax can be reduced below that which would be paid using an accurate transfer price.

There is some indication that the level of tax payments of foreign-owned businesses in the United States is unusually low: the ratio of income tax payments to total receipts (and assets) of foreign-controlled U.S. corporations were both less than half that of all U.S. corporations in 1986.[68] As the Treasury white paper on intercompany pricing noted, there is considerable suspicion that transfer pricing issues play a major role. Indeed, jurisdictional problems in the audit and enforcement of transfer prices specific to inbound direct investment was the spur behind the amendment of Code section 6038A in the 1989 Act, which provides for enhanced recordkeeping on transfer pricing issues. Despite these improvements, transfer pricing problems may still cause the impact of net taxation to fall less heavily on U.S. operations of foreign multinationals, and other changes to further enforce appropriate allocations of income may be necessary.

Some argue that a foreign multinational's incentive to avoid tax via transfer pricing manipulations is no greater than that for U.S. multinationals. Also, since industrialized countries' tax rates are typically higher than those prevailing in the United States, there may be no incentive to shift income back home, based on global tax minimization. Transfer pricing issues are endemic to a tax system that divides net income among jurisdictions based on an arm's length standard, and therefore are an unavoidable aspect of the tax system.

Issues analogous to transfer pricing issues also arise with U.S. branches of foreign corporations. For example, worldwide interest expense of the foreign corporation may be attributable to both its

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[68] Unpublished calculations from the *Statistics of Income*, Internal Revenue Service. The aggregate data do not adjust for the potentially different industrial mix of foreign direct investment.

U.S. and foreign operations, yet may not be legally or economically identified with any separate part of the enterprise. Allocation rules are required. The extent to which these rules achieve the appropriate allocation of income often engenders dispute.

One option for dealing with such problems of allocation is use of a formulary system. Under this method, the total worldwide net income of an enterprise is first determined. The income is then allocated to a particular taxing jurisdiction on the basis of objective factors associated with that jurisdiction, such as the fraction of employment, assets, and sales there. The formulary method, while having certain disadvantages of its own, avoids numerous allocation problems of present law. The approach is in widespread use for interstate allocations within the United States. Use of such a method for international allocations may represent a departure from present international norms. Some may argue that multilateral action is desirable in order to establish an equitable international tax system based on a formulary approach.

### *Withholding taxes*

#### *In general*

In addition to net income taxation of U.S. corporations and of the U.S.-effectively connected income of foreign persons, the United States asserts the right, as do most countries, to impose tax on payments of capital income earned on direct investment in the United States. This tax takes the form of withholding taxes on dividends, interest, rents, royalties, and the like. In addition, the branch taxes impose a second level of tax on repatriations from a U.S. branch. Withholding tax may apply to both direct and portfolio investment, but there are significant differences in the treatment of interest and dividends, in particular.

The United States, by statute, imposes a 30-percent withholding tax on most income earned by foreign direct investors in the United States. The U.S. model treaty would eliminate the tax on interest paid to direct investors, and reduce the rates to 5 percent on dividends paid to corporate direct investors and 15 percent on dividends paid to individual direct investors. The United States has entered into treaties that achieve these rates. Corporations that pay interest to direct investors that benefit from treaty reduced rates may be subject to limitations on interest deductions, under the earnings stripping provision of the Code.

Many people argue, particularly certain U.S. business interests investing abroad, that withholding rates should be reduced as low as possible. For a home country credit jurisdiction that limits the credit to the rate of home country tax, a withholding tax on top of the net income tax on business income, they maintain, is likely to bring the total rate of tax on such income above that which would prevail in the country of residence. Under a home country exemption system, any withholding tax represents an increase in tax burden on the investor. Thus, the additional imposition of withholding tax is not merely a method for allocating revenue between taxing jurisdictions, but may increase the amount of tax that would otherwise be due in the country of residence.[69] On a pragmatic level, supporters of foreign investment in the United States are concerned that withholding taxes will discourage such investment.

The flat 30-percent withholding rate on non-effectively connected income, insofar as it affects direct investors, has been part of the U.S. tax code virtually unchanged since 1966. Some supporters of the tax argue that it is an administratively simple method for obtaining a level of tax roughly equivalent to what the tax burden would be on similar income of a U.S. person. With top U.S. rates of 28 percent on individuals and 34 percent on corporations, a 30-percent withholding rate may be viewed as a fair approximation. Without a withholding tax, some argue, foreign persons will be advantaged over U.S. persons in the acquisition of U.S. capital, both in new investment and in the acquisition of existing companies.

Supporters of lower withholding rates argue that, while the rates appear similar to ordinary U.S. tax rates, the effective burden is much higher on foreign investors than on U.S. investors. The withholding tax is a tax on gross income, while the generally applicable income tax is a tax on net income. If, for example, the expenses of earning $100 of gross interest income were $50, net income would be $50. A 34-percent rate on net income would yield $17, while a gross withholding tax of 30 percent would yield $30 in the same case. Thus, the 30-percent withholding tax may be, in practice, substantially more burdensome than U.S. taxes on net income. The extent to which the withholding tax burden deviates from a burden based on net income depends on the fraction of income earned used for expenses—information that the source country may find excessively difficult to obtain accurately.

A final argument against the rough equality view of the 30-percent rate is that the rate has remained virtually unchanged for decades while top U.S. corporate and individual tax rates have decreased dramatically in the past 25 years.

A different argument to support high statutory rates of withholding is based on the strategic interaction with other countries. Because every nation may have the incentive to extract as large a fraction of tax revenue on inbound investment as possible, rates generally may be too high. If one country reduces rates, it may forego revenue with minimal offsetting gain. If two countries can mutually agree, however, to reduce rates, both may be made better off with smaller declines (or possibly increases) in tax revenue. Thus, as discussed further in Part III.F (below), statutory reductions of withholding rates may amount to unilateral tax disarmament, in that one of the strongest levers for obtaining concessions from the other country would be missing. This argument is particularly applicable to direct investment, in that direct investment may be more motivated by industry- and firm-level factors and less by small changes in after tax rates of return. The ability to extract tax revenue through high withholding taxes from direct invest-

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[69] This statement is equivalent to arguing that for a resident of a credit jurisdiction like the United States, the U.S. source-country tax on the income will generate excess foreign tax credits in the home country.

ment therefore may be greater than from portfolio investment, and the need for bargaining tools increases as well.

### *Withholding rates under tax treaties*

*Dividends.*—As previously discussed, tax treaties into which the United States has entered often reduce the rate of withholding tax on dividends paid by a corporation resident in one of the treaty countries to a shareholder resident in the other treaty country. The reduced rate of tax can be justified, it is argued, under the theory that it is appropriate for such a dividend to be taxed by both the country of source of the dividend and the country of residence of the shareholder, and that a 15-percent source country withholding tax rate, for example, provides an adequate division of the tax resulting from the dividend between the two countries. A 15-percent withholding tax rate is not excessively low, some maintain, considering the fact that the source country also has the ability to extract a tax from the profits of the corporate payor of the dividend. In many cases, treaties further provide for a 5-percent withholding tax rate by the source country on dividends paid by a subsidiary company to its parent company. The 5-percent rate generally reflects the view that the source country tax on distributions of profits to a substantial nonresident corporate shareholder may properly be reduced below the standard 15-percent rate to avoid double corporate-level taxation and to facilitate international investment.

*Interest.*—Unlike treaty reductions of withholding taxes on dividends, treaties often eliminate source country withholding tax rates on interest paid to direct investors, and indeed, such elimination has been a part of the expressed tax treaty policy of the United States. Some may argue that an anomaly exists where direct investment dividends bear double-level source country tax (i.e., 34 percent corporate-level tax and 5 or 15 percent shareholder level tax), yet interest paid to direct investors is both deductible at the corporate level and untaxed by the source country at the shareholder level. This is particularly troubling, it is argued, because of the identity of interest between the lender and borrower in the case of direct investment lending, and the resulting lack of market restraints on the amount of debt incurred. Furthermore, if it is believed that direct investment is insensitive (relative to portfolio investment) to levels of source country tax, then justifications for eliminating withholding tax on portfolio interest (discussed below) may be less relevant to the question whether the United States, as source country, should forego tax on interest paid to direct investors. Finally, where capital owned by the direct investor generates income from U.S. business operations, yet none of that income bears U.S. tax, it is argued that the ordinary basis for asserting jurisdiction to tax has been relinquished. The problem is said to be exacerbated by definitions of interest that do not distinguish between market or fixed rate payment obligations and obligations to pay amounts that vary with the profits of, or the appreciation of assets that belong to, the obligor. (Compare Treas. Reg. sec. 1.897–1(h), dealing with equity kickers, and the U.S. model treaty definition of "interest," with articles 10.5 and 11.2 of the 1989 German treaty.)

Thin capitalization, or earnings stripping rules can limit the relinquishment. In designing such rules, issues arise as to the appropriate U.S. share of tax from the U.S. operations. For example, if it is believed that the source country properly taxes at the corporate rate the entire return from operations to the capital supplied by the related investor, then no deductions would be allowed for related party payments representing remittances of such returns. Moreover, in identifying such payments, concern may properly be focused on amounts denominated as rents or royalties (and perhaps other types of payments as well) that are economically equivalent to interest.

Others argue that allowance must be made for the probability that the related lender is itself likely to have borrowed from an unrelated lender; in such a case the untimate provider of capital generally can receive no credit for withholding tax on the interest payments to the related party. Furthermore, to the extent that the ultimate capital provider is unrelated to the borrower, and not engaged in any U.S. business other than that of lending (indirectly) to a U.S. person, some may question whether a U.S. tax, especially if imposed at a 30 percent rate on a gross basis, is appropriate. Some suggest that the U.S. borrower and foreign related lender be required to treat worldwide, third-party interest expense as fungible, effectively allocating a pro rata portion of such expense to U.S. operations. Others argue that administrative difficulties preclude such a solution. It may be argued that there is some treaty withholding rate (e.g., 15 percent) above which the United States should allow full interest deductions at the corporate level regardless of the proportion of corporate pre-net-interest-expense income that is paid out as interest (the test for earnings stripping under current law), or regardless of other factors indicating thin capitalization. Some may argue that a 30 percent tax is higher than necessary to deter the stripping of earnings through interest payments in the case of a resident of a country with which the United States has a treaty. Such a taxpayer, it may be argued, is likely to be subject to tax on interest income at a rate not significantly less than U.S. rates.

Finally, insofar as thin capitalization rules applicable to foreign direct investors operate in practice differently than do the analogous rules applicable to domestic direct investors (which differences may be due to differing purposes of the two sets of rules) some may argue that this difference creates undesirable distortions.

### *Capital gains*

Although the United States asserts the right to tax nearly all forms of income paid to foreign persons, capital gains generally are not subject to tax.[70] From an economic perspective, some view this exception as a significant loophole, particularly in direct investment situations.

An example may illustrate the argument. If a U.S. corporation owned by a foreign person earns $1000 (net of U.S. corporate tax)

[70] Exceptions include gains from dispositions of U.S. real property interests, gains effectively connected with the conduct of a U.S. trade or business, gains attributable to a permanent establishment or fixed base, and gains of certain individuals taxable under section 871(a)(2).

and pays $1000 of dividends, $300 of withholding tax would be collected, at a 30-percent rate.[71] If the corporation instead retains the $1000 and the foreign person sells the stock of the corporation at a $1000 gain, no tax is assessed. The foreign person obtains the same pre-tax economic benefit in either case, but pays less U.S. tax under one scenario than the other.[72]

Concern about this method for avoiding tax on distributions from foreign-owned U.S. corporations may be most acute where the foreign investor has control over the distribution policy of the corporation. Thus, some have suggested that in cases of direct investment, gains upon sale or liquidation of stock should be taxed at least to the extent of undistributed earnings. Some argue further that a broader array of capital gains should be taxed, such as the total gain on sale of direct investment stock, or the sale of any U.S. asset.[73]

Proponents of a capital gains tax on foreign investors argue that such a tax is necessary to establish equity of tax treatment between foreign and domestic investors in order to prevent undue distortion in asset markets. A tax on capital gains, it may be claimed, would not constitute a penalty on foreign investors, nor would it discourage the flow of foreign investment capital into the United States. Instead, it is argued, a tax on capital gains would eliminate an inducement in the tax laws that first permits the foreign investor to minimize or eliminate current shareholder-level tax on an investment in stock of a U.S. corporation, for example, by trading current income (in the form of dividends) for unrealized appreciation (in the form of enhanced stock value resulting from retained earnings), and then effectively exempts the foreign person from U.S. tax when the appreciation is realized upon disposition of the stock.[74] Further, it is argued, experience since 1980 with FIRPTA indicates that gains taxes do not unduly inhibit foreign investment in U.S. assets affected by such a tax.

Defenders of the present system argue that the potential loophole is overstated and not representative of actual behavior. The collection of tax on a sale of a capital asset would, in addition, be administratively difficult, even in the case of direct investment. Finally, there has developed an international norm that capital gains are to be taxed on the basis of the residence of the seller, not the location of the asset. Deviation by the United States from this norm could, it is said, result in double levels of tax, discourage inbound investment, and upset somewhat arbitrary, but established principles for allocating tax revenue among jurisdictions. A change by the United States could, however, lead to a new and, some

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[71] A lower rate of tax may apply under treaties.

[72] The tax is not recovered when the distribution is made to the subsequent buyer, as the income recognized upon the dividend distribution will be offset by an equal capital loss, whether or not realized. Thus, tax is completely foregone at the shareholder level.

[73] A provision to impose tax on certain stock gains of 10 percent foreign owners passed the House of Representatives in 1989. H.R. 3299, 101st Cong., 1st Sess., sec. 11404 (1989). See H. Rep. No. 101-247, 101st Cong., 1st Sess. 1302 (1989).

[74] Similarly, it can be argued that with respect to direct investment in the United States via a foreign corporation that engages in a U.S. business, the United States should not both permit the corporation to minimize or eliminate branch profits taxes by reinvesting earnings and thus enhancing the value of the investment, and then exempt from branch profits tax the repatriation of those profits upon the termination of the United States business.

would argue, more rational international norm regarding the taxation of capital gains.

*Other policies regarding direct investment*

Many of the problems that some perceive with direct investment may not have remedies through the tax system. For instance, national security concerns, and concerns about the influence of direct investment in the economy and politics of the United States may be difficult to address through changes in the tax code.

To the extent that national security concerns need to be addressed, it may be more appropriate to address them on an industry or acquisition basis. Indeed, a variety of federal laws have been developed to restrict the role of foreign involvement in specific industries.[75] In addition, the Omnibus Trade and Competitiveness Act of 1988 provides for presidential review of mergers, acquisitions, and takeovers by foreign interests. The President may take steps to prohibit or alter the transaction if it might impair national security.

Some also call for increased reporting requirements on foreign investment. Better information collection is one rationale provided, as well as a concern over the identity and motives of foreign owners of U.S. property. It is argued that more complete disclosure will provide a more useful understanding of the economic and political impact of direct investment. Others argue that increased disclosure will have a major, adverse impact on foreign investment. In addition, disclosure requirements would move the United States in a direction opposite to that espoused by the United States as it tries to negotiate with other countries for fewer hindrances to the international flow of capital.

## E. Portfolio Investment

*Costs and benefits of portfolio investment*

The costs and benefits of portfolio investment should be considered relative to those for direct investment. The obvious difference, of course, is that portfolio investors generally have little in the way of control over the operations of the business enterprises. Thus, the advantages and disadvantages of direct investment may not be relevant to portfolio investment.

Because the economic motivation for portfolio investment differs from that for direct investment, the effects on the United States economy will differ as well. Direct investment usually depends heavily on specific firm and industry factors; portfolio investment depends much less on these factors. Portfolio investors typically make investments based on an analysis of the level of market returns at home and abroad.

Portfolio investment may be far more fickle and variable than direct investment. Direct investment often involves extensive managerial control and coordination with other operations of the controlling multinational enterprise. Portfolio investment is almost

[75] Michael Seitzinger, "Foreign Investment in the United States: Major Federal Restrictions," Congressional Research Service, Report No. 89-376 A, April 7, 1989.

always in the form of financial claims (e.g., bonds, equities, and bank deposits) which may be easily sold or transferred.

Some analysts have expressed concern that a massive movement out of U.S. investments by foreign investors would have a significant deleterious effect on the U.S. economy. If, for example, foreign investors anticipate higher future inflation or exchange rate depreciation, the expected rate of return on U.S. investments to foreign investors would decline, and foreign investors may choose to invest elsewhere. A sudden, large withdrawal of funds invested in the United States might disrupt financial markets and significantly raise U.S. interest rates.

The role of portfolio investment is substantial in certain markets. Between 15 and 20 percent of the publicly-held Federal debt is in foreign hands ($349.5 billion at the end of 1988), 26 percent of which is held by Japanese nationals.[76] Some believe that the concern about the reaction of foreign portfolio investors has placed limits on the range of public policy responses, particularly monetary policy actions. Direct investors, they claim, are less sensitive to monetary and other types of macroeconomic policy. Others claim that any such problem of foreign investment would be present, regardless of the form that the investment takes, but that the concern about foreign investment reactions is overstated and misplaced.

### *Tax policy and portfolio investment*

#### *In general*

The analysis of the taxation of portfolio investment parallels, in many ways, that of direct investment (see Part III.D). One major difference is that the concern about obtaining the appropriate amount of net income tax from business operations is greatly reduced. Portfolio investment generally will take the form of an obligation of a domestic corporation, individual, or domestic branch of a foreign corporation, all of which are subject, in the United States at least, to taxation on net income. The United States also provides special rules in the case of partnerships to insure that equity investments by foreign persons in partnerships engaged in U.S. business are subject to tax, and denies pass-through S-corporation status to any corporation with a foreign owner.

Another important difference between portfolio and direct investment is the potential responsiveness of portfolio investment to the tax imposed at source. Unlike direct investment, which may be able to earn above-market rates of return in particular countries due to firm-specific profit opportunities, portfolio investment will only be able to obtain the after-tax rate of return that an unrelated party is willing to pay. Although the portfolio investor may have a wide range of alternative investment opportunities, they are likely to offer roughly similar risk-adjusted rates of return. Thus, portfolio investors may be much more sensitive to the level of tax imposed on their investment than direct investors.

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[76] Philip D. Winters, "Foreign Held Federal Debt: Country Holdings," Congressional Research Service, (CRS Rept. No. 89-609 E), November 6, 1989.

If portfolio investment is more sensitive to tax rates than direct investment, then the ability for the source country to extract tax revenue from domestic portfolio investments of foreign persons may be less than its ability to extract revenue from direct investment. To the extent this is true, some argue that source country rates of tax on portfolio investment should be less than rates on direct investment. Others argue that a rate differential between portfolio and direct investment would distort the form of investment, and would lead to allocations of capital inferior to the allocation that would occur if all forms of investment were taxed identically.

*U.S. taxation of portfolio investment*

By statute, the United States nominally imposes 30-percent withholding tax on income paid to foreign persons from nearly all forms of portfolio capital, although tax treaties typically reduce the rate substantially on many forms of investment. Two very significant exceptions are the returns from capital gains on U.S. investments (other than U.S. real property interests) and on most interest paid to foreign persons on portfolio investments, including bank deposits. In both cases, no tax is imposed by the United States.

*Capital gains*

The arguments for and against the taxation of portfolio capital gains by the source country are similar to the arguments in the case of direct investment (see Part III.D). Some argue, however, that the ability of a portfolio investor to escape U.S. tax on investments in equities by limiting dividend distributions is less than in the direct investment case because the foreign investor is unable to control the distribution policy of the U.S. corporation. Others point out that foreign investors are free to purchase equities of corporations that follow a policy of retaining earnings instead of making dividend distributions. Also, it may be much easier for a portfolio investor to sell a small stake in a highly liquid, publicly traded corporation, and obtain tax-free capital gain treatment, than it is for a direct investor to sell all, or a large part, of a U.S. subsidiary.

*Portfolio interest*

Prior to 1984, the United States imposed a 30-percent withholding tax on portfolio interest (which excluded payments on bank deposits) in the United States. Treaties reduced the rate for investors in many countries, in certain important cases to zero.

In 1984 the withholding tax on portfolio interest was repealed. Supporters of the repeal emphasized that the withholding tax, as in effect before 1984, was discriminatory in that large U.S. corporations were able to avoid, primarily through the use of the tax treaty with the Netherlands Antilles, the impact of the withholding tax on their borrowings while the Federal Government and small business could not avoid the affect of the tax. Payments of interest on foreign deposits in U.S. banks also were not subject to the tax. Thus, it was argued that the withholding tax unfairly distorted the distribution of capital among various categories of borrowers.

Some supporters of repeal also argued that the withholding tax repeal would reduce the interest rates that some U.S. borrowers would be required to pay and might reduce the level of interest rates overall. Even some of the supporters of repeal, however, admitted that the effect on interest rates, if any, would be so small as to be undetectable.

The amount of revenue raised by the withholding tax on portfolio interest was $153 million in 1982. Supporters of repeal argued that the amount of revenue raised was not worth the impact it had on interest rates and capital flows. Indeed, some of those who contended that the repeal would reduce borrowing costs to the Federal Government believed that the savings in interest payments would exceed foregone tax revenue.

Some analysts maintain that a well-designed portfolio tax would raise significant revenue and be beneficial to the United States and to the international tax system. The problems with the previous withholding tax were in the specifics of the design and not the underlying concept.[77]

Exempting interest from withholding, while other types of capital returns paid to foreigners are subject to tax, distorts the choice of investments, in particular in favor of debt instead of equity. Some argue that this distortion reduces the efficient use of foreign capital raising the effective cost of capital available in the United States. Others claim that it is in the best interest of the United States for foreign persons to lend money instead of investing in equities that may permit a greater degree of control over U.S. business.

Some have proposed a withholding tax on all types of interest at a low rate, perhaps 5 percent.[78] Such a tax, supporters contend, would avoid many of the problems of the previous tax. They maintain that a low rate of tax on all interest would avoid the allocative distortions that plagued the previous attempt and would have a very small, if any, impact on U.S. interest rates. First, they contend, the tax would be creditable in many countries, especially if the withholding rate were well below income tax rates in such countries, and thus would impose no additional tax burden on many existing investors. Second, foreign investors would reorganize investments so that more U.S. borrowings are in the hands of foreign investors who would be able to credit the tax in their home country, so the impact of the tax would be even smaller than one might otherwise presume. Moreover, the United States is a large, stable economy that is desirable to foreign investors. A small de-

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[77] The problems were described to Congress in 1980 by a representative of the Carter Administration as follows:

> [I]t seems to me that the present situation, where we have a nominal tax in the statute, with exceptions that make the statute look like Swiss cheese, is really the worst situation of all. We should go one way or the other. We should either impose a tax on interest, or we should relieve the tax on interest.
>
> But to have a tax of 30 percent on interest in the Code and then have historically based exceptions that have arisen over time creates all sorts of anomalies, unfairness, and inefficiencies.

*Income Tax Treaties: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways & Means*, 96th Cong., 2d Sess. 111-12 (1980) (statement of H. David Rosenbloom, International Tax Counsel, Department of the Treasury).

[78] Lawrence Summers, "A few good taxes: revenues without tears," *The New Republic, November 30, 1987, p. 14.*

cline in after-tax interest rates would have a small impact on the amount of lending into the country. Finally, the tax would be particularly valuable since the United States has become a net debtor nation. In summary, supporters believe that the United States could obtain a substantial amount of tax revenue while increasing the allocative efficiency of foreign capital in the United States.

Detractors claim that any amount of tax would significantly deter foreign investors from lending into the United States, as not all investors would be able to receive full credit for the tax. Interest rates will need to rise, they assert, until the after-tax rates of return to investors are restored to the level prevailing before the introduction of the tax. This would have a deleterious effect on the level of investment in the United States. Further, because a large amount of cross-border lending is involved in international banking activities, U.S. financial institutions would be at a competitive disadvantage compared to those from other countries. This would be particularly so as even a low rate gross basis withholding tax may represent an extremely high rate when compared to the net income that financial intermediaries may generate from bank deposits from foreign persons.

*Capital flight and international tax evasion*

One aspect of the debate over a portfolio interest tax is concerned with the role of capital flight in the global economy. Some believe that a substantial amount of cross-border portfolio lending involves capital leaving unstable economies or funds that are invested abroad in order to evade home country tax. It is extremely difficult for most countries tax authorities to discover income from portfolio investments placed abroad, particularly if the investor deliberately intends to evade tax.

Several small countries have intentionally established themselves as tax havens, with no or low tax on investments received from abroad and tight investor secrecy laws. This policy is designed to attract large amounts of financial capital to establish an offshore financial industry that, while small in a global sense, can significantly affect the economy of very small nations. The capital attracted, however, can not be profitably invested in physical assets located in the tax haven, but is reinvested by financial intermediaries in large industrialized countries.

International tax evasion may be widespread, even without the use of tax havens. One impact of international tax evasion is to distort the allocation of capital. If income from capital invested abroad is not effectively taxed, while domestic income from capital is taxed, then investors have an incentive to invest abroad instead of in their home country. This allocative distortion reduces the efficiency of the existing capital stock.

Withholding tax may be one of the most effective ways for reducing capital flight and international tax evasion. Since the tax can be collected by the payor, the ability to evade the tax may be quite small.

The European Community, in planning for the reduction in cross-border capital controls, is considering the use of a withholding tax as a means of avoiding tax evasion that it is feared may otherwise occur. Indeed, the United States, when it repealed the portfolio interest withholding tax in 1984, passed restrictions on the use of certain types of debt instruments in an attempt to reduce the amount of tax evasion by U.S. persons who would invest in the United States by presenting themselves as foreign persons.

Some have suggested that the United States could provide leadership on the problem of international tax evasion by the enactment of a tax on portfolio interest. This may be particularly true in the next few years, as the European Community is struggling with the problem that the upcoming economic integration presents. Action by the United States may spur other major countries to follow suit, and a significant improvement in the international fiscal regime might ensue. Since investments, regardless of the layers of intermediation involved, will mostly flow into the industrialized countries, concerted action by the industrial countries could prove advantageous to all. Even without concerted action, some supporters maintain that the purely national benefits of a portfolio withholding tax outweigh the costs, and any improvements in the international fiscal regime would be a beneficial side effect.

Others suggest that unilateral action by the United States in an attempt to reduce international tax evasion (which might not be viewed by some as a particular concern of the United States) would be fruitless. They contend there are far too many options for investing and that the United States is too small, from a global perspective, to have any significant overall effect. Moreover, they contend that the problem of international tax evasion is overstated.

Even if international tax evasion is deemed important, bilateral and multilateral information reporting is a more appropriate solution, some argue. This method could cope with the problem without the distortion that a withholding tax might create. Others suggest that the call for international information reporting is administratively unrealistic. They point out that limited attempts to administer certification systems, even on a small scale, have been extremely ineffective.

## F. Tax Treaties

### *Influencing the acts of foreign governments*

Treaties have the potential to benefit the United States insofar as they affect the actions of foreign sovereigns in ways that internal U.S. law cannot. Treaties (or other international agreements) can provide for mutual cooperation on tax law enforcement, in the same way that other law enforcement functions are often enhanced by cooperation among law enforcement jurisdictions. Treaties can provide dispute resolution mechanisms for three-way disputes involving one taxpayer and the two governments, preferably in such a way that each party's legitimate views are taken into account at the proper time by each other party. Indeed, in cases involving real dangers of double taxation, such as dual residency or conflicting source rules, treaties can provide a set of rules for purposes of determining the outcomes of such disputes.

Some may also argue that, in a world where different countries cannot realistically be expected universally to coordinate tax rates and the legal bases for asserting tax jurisdiction, and where some countries may impose tax provisions affecting U.S. residents thought to be undesirable from a U.S. perspective, treaties may result in the beneficial alteration of those rules.

To induce foreign governments to modify their behavior in the ways described above, some would argue that an appropriate inducement is the reduction of U.S. source-basis taxation of foreign persons on a bilateral, rather than a unilateral (i.e., statutory) basis. Indeed, some may argue that to increase U.S. bargaining power in such a situation, it is desirable that statutory rules applicable to inbound foreign investment be, in some respects, overly burdensome.

Some may also argue that it is appropriate to tax the residents of different countries differently in certain respects. For example, a country that exempts from income tax all foreign source income, or that imposes no income tax, is generally not considered to be an appropriate partner for a treaty that would reduce U.S. source country tax on its residents. Thus, even though it may be appropriate to reduce to 5 percent the withholding tax on dividends paid to a direct corporate investor resident in a high tax jurisdiction, it will be inappropriate to so reduce the withholding tax on dividends paid to a resident of a no-tax jurisdiction. Although country-by-country distinctions have been drawn in the Code respecting outbound U.S. investment,[79] accounting for such distinctions through treaties has the perceived virtue of allowing the United States to extract a benefit in return for providing country-specific concessions.

Under a perhaps extreme view of concession extraction, reductions in foreign tax imposed on U.S. persons might be considered an important treaty goal *because* the United States is a net exporter of capital to a particular country. Thus, it may be in the interests of the United States to give and receive rate reductions only in those cases where the United States stands to gain more by the rate reductions than the other country (assuming the other country is willing to enter into a treaty on such a basis). On this theory, there is no justification for U.S. rate reduction *unless* there is reciprocal rate reduction; further, there is no justification for U.S. rate reduction unless there is more foreign tax to be saved by U.S persons than there is U.S. tax to be foregone from U.S. persons. Of course, were all countries to adopt this strategy, there would be virtually no bilateral tax treaties in the world. Others argue that regardless of differences in inflows and outflows of capital, treaties are generally beneficial to both treaty partners insofar as they foster a more efficient allocation of capital by their residents.

### *Limitation on benefits*

If the premise of the foregoing arguments is accepted, then the concessions that a foreign government will be willing to make to U.S. interests will be related to the incremental benefits it can obtain by negotiating its own treaty with the United States. If its residents can, through use of a U.S. treaty with a third country (i.e., treaty shopping), obtain some or all of the possible alterations

[79] See, e.g., Code secs. 901(j) and 952(a)(5), which deny foreign tax credits and prevent deferral with respect to income from countries unilaterally designated by the United States.

in Code rules to which the United States is prepared to agree in its treaties generally, then a substantial rationale for that foreign country's willingness to make treaty concessions to the United States may be absent. Some would argue that in order to maximize its bargaining power, the United States must carefully circumscribe taxpayer benefits available under treaties so as not to be available to third-country residents.

Some might argue, on the other hand, that tax policy should be designed primarily to eliminate frictions that might impede global movements of capital (including capital provided from abroad to U.S. entities the foreign taxes of which are intended to be reduced by U.S. treaties). Therefore, although frictions built into the tax code, and anti-treaty shopping provisions in treaties, may serve as useful bargaining tools, an overly strict or broad anti-treaty shopping policy inevitably entails less-than-optimal resource allocation decisions. Under this argument, presumably, the appropriate anti-treaty shopping attitude involves a trade-off between bargaining power to induce the friction-reducing alterations in foreign tax laws, on the one hand, and the perceived detriments caused by anti-treaty shopping rules themselves, on the other hand.

Finally, there is room for disagreement over the proper criteria for determining that an entity is treaty shopping. As the branch tax definition of "qualified resident" and the recent treaty limitation on benefits clauses demonstrate, numerous criteria can be considered. Some are difficult to apply in practice. For example, some treaty shopping rules are based on the identities of the beneficial owners of entities that seek treaty relief. Such identification can be problematic, especially in large organizations with diverse ownership interests. Base erosion rules are based on the identities of the beneficial owners of payments from the entity, a criterion even more remote from the knowledge of tax administrators. Other criteria include the location of an exchange on which the entity's stock is traded. Such a criterion may be based on an expectation that public trading in a stock suggests that the entity is regulated in some way that precludes its use as a nominee solely for the tax purposes of foreign controlling interests, or more simply that local residents tend to be more likely than foreign persons to own shares in companies traded on a local exchange. However, the location of the exchange may more properly be viewed as immaterial in a globally integrated stock market. Finally, the identity of the stockholder or other interest holder can be itself an uncertain guide to beneficial ownership of activities and income generated by the corporation, in light of the variety of interests that can be bestowed under the name "stock," and given the fact that interests of stockholders can be relatively insignificant relative to the interests of other investors or recipients of payments from the corporation.[80]

Criteria based on business activities of the entity in the treaty country, or tax status of the entity in the treaty country, can be used as indications of treaty shopping. Again, depending upon how strictly such criteria are applied, they may produce frictions thought incompatible with worldwide markets, or rational adminis-

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[80] Kingson, *The Coherence of International Taxation*, 81 Colum. L. Rev. 1151, 1279 (1981).

tration, or on the other hand they may be insufficiently strict to prevent substantial levels of treaty shopping.[81]

Enforcement problems pertaining to the availability of treaty benefits are related to the problem of third-country residents attempting to qualify under objective criteria for treaty benefits that were not designed for them. In particular, concern has been expressed by some that the U.S. tax rate reductions and exemptions provided in U.S. tax treaties have been availed of to a possibly significant degree by third-country residents not entitled to treaty benefits, but who have their U.S. source income paid to a nominee or address in a treaty country. The current address/self-certification system relies on uncertified information provided by the taxpayer, and provides little opportunity or effective power to the IRS, it is argued, to examine the entitlement to treaty relief. Some have argued that either a third-party certification system or a refund system would prevent many of the abuses possible under the present system.

*Treaty interaction with later-enacted statutes*

A complaint that has been voiced with respect to tax laws from time to time has been that they change too rapidly. These changes upset prior expectations or projections, introducing an additional element of randomness into the expected future net returns from current economic decisions.

An aggravated form of this complaint is said by some to arise in connection with treaties. Notwithstanding the general rule of construction that statutes are to be construed harmoniously to the extent possible with existing treaties [82] (and, for that matter, existing statutes [83]), Congress from time to time desires to depart from existing tax policy in one or another respect, perhaps even altering substantially, in the view of one or both of the treaty partners, the basis on which a prior treaty was agreed to.

When a treaty partner's internal tax laws and policies change, treaty provisions designed and bargained to coordinate the predecessor laws and policies may be reviewed for purposes of determining how those provisions apply under the changed circumstances. There are cases where giving continued effect to a particular treaty provision does not conflict with the policy of a particular statutory change. In certain other cases, however, a mismatch between an existing treaty provision and a newly-enacted law may exist, in which case the continued effect of the treaty provision may frustrate the policy of the new internal law. In some cases the continued effect of the existing treaty provision would be to give an unbargained-for benefit to taxpayers or one of the treaty partners. At that point, the treaty provision in question may no longer elimi-

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[81] *See generally* Rosenbloom, *Tax Treaty Abuse: Policies and Issues,* 15 L. & Pol. Int'l. Bus. 763 (1983).

[82] "When [a treaty and a statute] relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either." *Whitney v. Robertson,* 124 U.S. 190, 194 (1888).

[83] In the case of two statutes, "[t]he cardinal rule is that repeals by implication are not favored. Where there are two acts upon the same subject, effect should be given to both if possible. . . . [T]he intention of the legislature to repeal must be clear and manifest." *Posadas v. National City Bank,* 296 U.S. 497, 503 (1936).

nate double taxation or prevent fiscal evasion; if not, its intended purpose would no longer be served.

Various alternatives are presented: statutory override (either immediate or delayed) of some or all of the obligations contained in an existing treaty or treaties, or strict adherence to the treaty, subject to the outcome of renegotiations, if any.

Some have argued that existing treaties should be conformed to changing U.S. tax policy solely by treaty renegotiation. However, once U.S. tax policy has changed, the existence of an unbargained-for benefit created by the change may have the effect of making renegotiation to reflect the new tax policy extremely difficult, because the other country may have little or no incentive to remove an unbargained-for benefit whose cost is borne by the United States.

Others have argued that statutory override of particular provisions is desirable in some cases.[84] Still others would argue that a statutory override is an appropriate alternative to renegotiation, but only if the entire treaty is terminated.[85]

Parties to the treaty can also differ as to whether the continued effect of a treaty provision in light of a particular statutory change provides a significant unbargained-for benefit or otherwise frustrates the basic objectives of tax treaties. Remedies may be available in the case of what one party views as a breach of international law.

Some argue that treaty partners and potential treaty partners may consider that the value of negotiations or concessions is lessened to the extent that the expected lifetime of the bargain appears to shorten. Moreover, even if no treaty is violated, it is sometimes necessary in the legislative process for Congress to determine whether a treaty is or is not in conflict with a particular provision. If there is a dispute about that issue, there may be no tribunal to which the treaty partner can appeal until the law is passed. The expectation that such disputes will arise out of legislation subsequent to the negotiation of a treaty may in itself be argued to lessen the perceived desirability of making treaty concessions. On the other hand, others argue that the alternatives, namely, to constrain the constitutional responsibility of the Congress and Executive to make those laws viewed as appropriate to U.S. tax policies, or to give up entire treaties whenever single provisions are affected, are the more undesirable outcomes.

Various methods have been suggested to alleviate the problems that arise from potential statutory conflicts with treaties. One such alternative might be entering into treaties on the mutual understanding that the treaties will automatically terminate after a term of years. Another option has been to make any statutory override of treaty provisions generally effective only after a number of years (for example, three) during which renegotiations would take place. Treaties themselves could contain clauses in which the par-

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[84] Section 31 of the Revenue Act of 1962; section 601 of the Tax Reduction Act of 1975 as interpreted in Rev. Rul. 80-223, 1980-2 C.B. 217; section 1125(c) of FIRPTA; section 1012(aa) of the 1988 Act; section 11404(e) (3) and (4) of the H.R. 3299, 101st Cong., 1st Sess. (1989).

[85] See, for example, section 313 of the Anti-Apartheid Act of 1986 (P.L. 99-440, 22 U.S.C. 5001) which terminated the income tax treaty and protocol between the United States and South Africa effective July 1, 1987.

ties agree not to give effect to overriding legislation during a similar term of years. Treaties could also contain provisions permitting the competent authorities, in the event certain internal law changes take place, to consult to determine whether a particular provision should be modified or cease to have effect (such a provision appears in Article 11 of the U.S.-France estate, inheritance, and gift tax treaty, which contemplates such consultation in the event of changes in internal laws on community property and marital deductions).

***Procedural concerns***

Some have argued that the very notion of altering U.S. statutory tax law by treaties is problematic. In addition to the problem of overrides discussed above, concerns have been expressed from time to time that coordination between the Executive branch negotiators and Congress were insufficient or that the "package" nature of the treaty bargain precludes congressional review of policies underlying individual pieces of the bargain. It further may be argued that the constitutional requirement that bills for raising revenue originate in the House of Representatives [86] is violated by a system in which major tax policy is enacted through treaties without officially being subject to consideration by the House and its committees. However, others note that the direct impact of treaties is to *reduce* tax receipts from foreign residents, and only as a secondary effect can they *raise* revenue—namely, by reducing the imposition of creditable foreign taxes on U.S. residents. Constitutional issues about the power to enact through treaties any laws that could not validly be enacted by statute, or otherwise about the reach of the treaty power generally, are beyond the scope of this pamphlet, although they may be directly relevant to this issue.[87] An alternative to using the normal treaty process, which may alleviate some of these concerns and avoid constitutional issues, would be to enter into income tax agreements that are not self-executing; i.e., that require an act of Congress to carry out the international obligation.[88] Apparently, in Western parliamentary systems, use of non-self-executing treaties is the rule, rather than the exception.[89] However, such a system may give no assurances that overrides would not occur, since typically legislation short of a constitutional amendment does not prevent a subsequent statute from taking effect, even if the latter act is inconsistent with first. To the extent that unilateral acts adversely affecting a treaty bargain are particularly disfavored, it may be argued that tax treaties are particularly unsuited for adoption without full bicameral action. Others may argue, on the other hand, that adequate coordination with the House during the processes of negotiation and Senate advice and consent makes such bicameral action unnecessary and perhaps undesirable.

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[86] U.S. Const. art. I, sec. 7, cl. 1.
[87] *See generally* L. Henkin, *Foreign Affairs and the Constitution* 137–56 (1975).
[88] L. Henkin, *Foreign Affairs and the Constitution* 156-58 (1975).
[89] *Id.*

## G. Estate and Gift Tax

It is important, as a matter of tax legislative policy, to consider the circumstances under which it is appropriate for the United States to impose estate and gift taxation on property transfers from nonresident aliens or their estates. While the transfer tax system is intended to raise revenue, some argue that it is also intended to achieve broader social objectives, including enhancing the progressivity of the overall Federal tax burden and affecting the distribution of wealth in society. Another policy consideration, relevant primarily to nonresident aliens, is the effect that broad imposition of the U.S. estate and gift tax might have on decisions to invest inside or outside the United States.

Some may argue that regardless of the theoretical basis for applying the estate and gift tax to nonresident aliens, in practice the tax is very difficult to enforce with respect to such persons. Indeed, in view of the possibilities for exempting what is effectively U.S. property from the tax, some may argue that it is little more than a trap for the unwary. (The principal examples of U.S. property that is expressly exempted from tax are bank deposits and portfolio debt; in addition, other U.S. property may sometimes be rendered exempt by being held through a foreign corporation.)

Those who argue that the base subject to transfer taxes on nonresident aliens should be broadened may suggest the devotion of more resources to enforcement of the current system as applied to a broader base, or that transfer taxes, as applied to foreign persons, be replaced by a more mechanically enforceable system, designed to collect approximately the same amount as the estate and gift tax would collect if imposed on a broader base than that under present law. If on the other hand it is believed that broad imposition is not desirable, then the effect of current law could be achieved more simply by exempting nonresident alien decendents' estates.

Enactment of the branch tax in 1986 may have significantly altered the importance of estate and gift taxes with respect to foreign persons who make real estate and direct (as opposed to portfolio) investments in the United States. With the branch tax regime in place, ownership of property in the United States now generally results in either potential liability for a transfer tax, or imposition of a second level of income tax. Therefore, some may argue that the model U.S. estate and gift tax treaty should be reexamined in light of the enactment of the branch tax.

## APPENDIX

Reproduced on the following pages is Table 1 from "Withholding of Tax on Nonresident Aliens and Foreign Corporations (For Withholding in 1990)," IRS Publication 515, pp. 20-21. The table shows the withholding rates applicable under all U.S. tax treaties, listed by country. The last line of the table, labeled "Other countries," shows the withholding rates applicable under the Internal Revenue Code in the absence of any treaty.

The column of the table labeled "Capital gains" should be read in conjunction with the discussion in Part II.D.1 of the text, which explains that capital gains realized by foreign persons are not generally subject to tax in the United States. Likewise, column 1 of the table, labeled "Interest paid by U.S. obligors, general," covers only a limited set of circumstances; the discussion in Part II.D.1 discusses these circumstances, as well.

# Table 1.—Withholding Tax Rates on Income Other Than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties—For Withholding in 1990

| Income code number | | 1 | 2 | 3 | 5 | | | 6 | 7 | 9 | 10 | 11 | 12 | 13 | 14 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Country of residence of payee | | | | | Interest on tax-free covenant bonds issued before 1934 | | | Dividends paid by | | | | Copyright royalties | | | |
| Name | Code | Interest paid by U.S. obligors general | Interest on real property mortgages | Interest paid to controlling foreign corporations | If obligor assumes more than 2% of tax | If obligor assumes 2% or less of tax | Maturity date extended after 1933 and obligor assumes over 27½% of tax | U.S. corporations general[f] | U.S. subsidiaries to foreign parent corporations[e] | Capital gains[u] | Industrial royalties | Motion pictures and televison | Other | Real property income and natural resources royalties[u] | Pensions and annuities |
| Australia | AS | [g]10 | [g]10 | [g]10 | 2 | [g]10 | [g]10 | [g]15 | [g]15 | 30 | [g]10 | [g]10 | [g]10 | 30 | [d]0 |
| Austria | AU | [h]0 | 30 | [h]0 | [h]0 | [h]0 | [h]0 | [h]15 | [b,h]5 | 30 | [h]0 | [h]10 | [h]0 | 30 | [d]0 |
| Barbados | BB | [g]12½ | [g]12½ | [g]12½ | 2 | [g]12½ | [g]12½ | [g]15 | [b,g]5 | [g,l]0 | [g]12½ | [g]12½ | [g]12½ | 30 | [d,l]0 |
| Belgium | BE | [g]15 | [g]15 | [g]15 | 2 | [g]15 | [g]15 | [g]15 | [b,g]5 | [e,g,l]0 | [g]0 | [h]0 | [g]0 | 30 | [d,l]0 |
| Canada | CA | [g]15 | [g]15 | [g]15 | 2 | [g]15 | [g]15 | [g]15 | [g]10 | [l]30 | [g]10 | [g]10 | [g]0 | 30 | [l]15 |
| China, People's Republic of | CH | [g]10 | [g]10 | [g]10 | 2 | [g]10 | [g]10 | [g]10 | [g]10 | 30 | [g,v]10 | [g]10 | [g]10 | 30 | [d]0 |
| Cyprus | CY | [g]10 | [g]10 | [g]10 | 2 | [g]10 | [g]10 | [g]15 | [b,g]5 | [g,l]0 | [g]0 | [g]0 | [g]0 | 30 | [d,l]0 |
| Denmark | DA | [h]0 | [h]0 | [h]0 | [h]0 | [h]0 | [h]0 | [h]15 | [b]5 | 30 | [h]0 | [h]0 | [h]0 | 30 | [d]0 |
| Egypt | EG | [h]15 | 30 | [h]15 | 2 | [h]15 | [h]15 | [h]15 | [b,h]5 | [e,h,l]0 | [h]0 | [h]0 | [g]15 | 30 | [d,l]0 |
| Finland | FI | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [b,g]5 | [e,g,l]0 | [g]0 | [g]0 | [g]0 | 30 | [d,l]0 |
| France | FR | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [b,g]5 | [e,g,l]0 | [g]5 | [g]0 | [g]0 | 30 | [d,l]0 |
| Germany, Fed. Rep. of | GE | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [g]15 | [e,g,l]0 | [g]0 | [g]0 | [g]0 | 30 | [d]0 |
| Greece | GR | [h]0 | [h]0 | 30 | [h]0 | [h]0 | [h]0 | 30 | 30 | 30 | [h]0 | 30 | [h]0 | 30 | [d]0 |
| Hungary | HU | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [b,g]5 | [g,l]0 | [g]0 | [g]0 | [g]0 | 30 | [d,l]0 |
| Iceland | IC | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [b,g]5 | [e,g,l]0 | [g]0 | 30 | [g]0 | 30 | [d,l]0 |
| Ireland | EI | [c,h]0 | [c,h]0 | 30 | [c,h]0 | [c,h]0 | [c,h]0 | [c,h]15 | [b,c,h]5 | 30 | [c,h]0 | [c,h]0 | [c,h]0 | [c,h]15 | [d]0 |
| Italy | IT | [g]15 | [g]15 | [g]15 | 2 | [g]15 | [g]15 | [g]15 | [b,g]5 | [g,l]0 | [g,s]10 | [g]8 | [g]5 | 30 | [d,l]0 |
| Jamaica | JM | [g]12½ | [g]12½ | [g]12½ | 2 | [g]12½ | [g]12½ | [g]15 | [b,g]10 | [g,l]0 | [g]10 | [g]10 | [g]10 | 30 | [d,l,p]0 |
| Japan | JA | [g]10 | [g]10 | [g]10 | 2 | [g]10 | [g]10 | [g]15 | [b,g]10 | [e,g,l]0 | [g]10 | [g]10 | [g]10 | 30 | [d]0 |
| Korea, Rep. of | KS | [g]12 | [g]12 | [g]12 | 2 | [g]12 | [g]12 | [g]15 | [b,g]10 | [e,g,l]0 | [g]15 | [g]10 | [g]10 | 30 | [d,l]0 |
| Luxembourg[k] | LU | [h]0 | 30 | [h]0 | [h]0 | [h]0 | [h]0 | [h]15 | [b,h]5 | 30 | [h]0 | [h]0 | [h]0 | 30 | [d]0 |
| Malta | MT | [g]12½ | [g]12½ | [g]12½ | 2 | [g]12½ | [g]12½ | [g]15 | [b,g]5 | [g,l]0 | [g]12½ | [g]12½ | [g]0 | 30 | 0 |
| Morocco | MO | [g]15 | [g]15 | [g]15 | 2 | [g]15 | [g]15 | [g]15 | [b,g]10 | [e,g,l]0 | [h]10 | [g]10 | [g]10 | 30 | [d,l]0 |
| Netherlands | NL | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [b,g]5 | [e,g,l]0 | [g]0 | [g]0 | [g]0 | 30 | [d]0 |
| Netherlands Antilles, Aruba[m] | NA, AA | [m]0 | 30 | 30 | 30 | 30 | 30 | 30 | 30 | 30 | 30 | 30 | 30 | 30 | 30 |
| New Zealand | NZ | [g]10 | [g]10 | [g]10 | 2 | [g]10 | [g]10 | [g]15 | [g]15 | [g,l]0 | [g]10 | [g]10 | [g]10 | 30 | [d]0 |
| Norway | NO | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [g]15 | [e,g,l]0 | [g]0 | [h]0 | [g]0 | 30 | [d,l]0 |
| Pakistan | PK | 30 | 30 | 30 | 2 | 30 | 27½ | 30 | [b,h]15 | 30 | [h]0 | 30 | [h]0 | 30 | [d,l]0 |
| Philippines | RP | [g]15 | [g]15 | [g]15 | 2 | [g]15 | [g]15 | [g]25 | [b,g]20 | [g,l]0 | [g]15 | [g]15 | [g]15 | 30 | [g]30 |
| Poland | PL | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [b,g]5 | [e,g,l]0 | [g]10 | [g]10 | [g]10 | 30 | 30 |
| Romania | RO | [g]10 | [g]10 | [g]10 | 2 | [g]10 | [g]10 | [g]10 | [g]10 | [e,g]0 | [g]15 | [g]10 | [g]10 | 30 | [d,l]0 |
| Sweden | SW | [h]0 | [h]0 | [h]0 | [h]0 | [h]0 | [h]0 | [h]15 | [b,h]5 | [h,l]0 | 0 | 0 | 0 | 30 | [d]0 |
| Switzerland | SZ | [h]5 | [h]5 | [h]5 | 2 | [h]5 | [h]5 | [h]15 | [b,h]5 | 30 | [h]0 | [h]0 | [h]0 | 30 | [d]0 |
| Trinidad & Tobago | TD | 30 | 30 | 30 | 2 | 30 | 27½ | 30 | 30 | 30 | [g]15 | 30 | [g]0 | 30 | [d,l]0 |

# Table 1.—Continued

| Income code number | | 1 | 2 | 3 | 5 | | | 6 | 7 | 9 | 10 | 11 | 12 | 13 | 14 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Country of residence of payee | | | | | Interest on tax-free covenant bonds issued before 1934 | | | Dividends paid by | | | | Copyright royalties | | | |
| Name | Code | Interest paid by U.S. obligors' general | Interest on real property mortgages | Interest paid to controlling foreign corpora-tions | If obligor assumes more than 2% of tax | If obligor assumes 2% or less of tax | Maturity date extended after 1933 and obligor assumes over 27½% of tax | U.S. corpora-tions general[a] | U.S. sub-sidiaries to foreign parent corpora-tions[a] | Capital gains[u] | Indus-trial royalties | Motion pictures and televison | Other | Real property income and natural resources royalties[u] | Pensions and annuities |
| Union of Soviet Socialist Republics | UR | [n]0 | 30 | 30 | 2 | 30 | 27½ | 30 | 30 | [o]0 | 0 | 0 | 0 | 30 | 30 |
| United Kingdom | UK | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [b,g]5 | 30 | [g]0 | [h]0 | [g]0 | 30 | [d,g]0 |
| Other countries | OC | 30 | 30 | 30 | 2 | 30 | 27½ | 30 | 30 | 30 | 30 | 30 | 30 | 30 | 30 |

[a]No U.S. tax is imposed on a percentage of any dividend paid by a U.S. corporation that received at least 80% of its gross income from an active foreign business for the 3-year period before the dividend is declared. (See sections 871(i)(2)(B) and 881(d) of the Internal Revenue Code.)

[b] The reduced rate applies to dividends paid by a subsidiary to a foreign parent corporation that has the required percentage of stock ownership. In some cases, the income of the subsidiary must meet certain requirements (e.g. a certain percentage of its total income must consist of income other than dividends and interest). In the case of Italy, the reduced rate is 10% if the foreign corporation owns 10% to 50% of the voting stock (for a 12-month period) of the company paying the dividends.

[c] The exemption or reduction in rate applies only if the recipient is subject to tax on this income in the country of residence. Otherwise a 30% rate applies.

[d] Exemption does not apply to U.S. Government (federal, state, or local) pensions and annuities; a 30% rate applies to these pensions and annuities. In the case of the United Kingdom, U.S. government pensions paid to individuals who are both U.K. residents and nationals are exempt from U.S. taxation.

[e] The treaty exemption that applies to U.S. source capital gains includes capital gains under section 871(a)(2) if they are received by a nonresident alien who is in the U.S. for not more than 183 days. (182 days for Belgium and Egypt.)

[f] Includes alimony.

[g] Under the treaty the exemption or reduction in rate does not apply if the recipient has a permanent establishment in the United States and the property giving rise to the income is effectively connected with this permanent establishment. In the case of Australia, Barbados, Canada, China, Cyprus, France, Hungary, Italy, Jamaica, Malta, New Zealand, Philippines, and the United Kingdom, the exemption or reduction in rate also does not apply if the property giving rise to the income is effectively connected with a fixed base in the United States from which the recipient performs independent personal services (professional services for royalties paid to a Philippines resident). Even with the treaty, if the income is not effectively connected with a trade or business in the United States by the recipient, the recipient will be considered as not having a permanent establishment in the United States under IRC section 894(b).

[h] Under the treaty the exemption or reduction in rate does not apply if the recipient is engaged in a trade or business in the United States through a permanent establishment that is in the United States. However, if the income is not effectively connected with a trade or business in the United States by the recipient, the recipient will be considered as not having a permanent establishment in the United States for the purpose of applying the reduced treaty rate to that item of income. IRC section 894(b).

[i] Bangladesh has not indicated that it wishes to assume the responsibilities or exercise the rights of the United States—Pakistan income tax treaty.

[j] Exemption is not available when paid from a fund, under an employees' pension or annuity plan, if contributions to it are deductible under U.S. tax laws in determining taxable income of the employer.

[k] Exemption from or reduction in rate of does not apply to income of holding companies entitled to special tax benefits under the laws of Luxembourg.

[l] Exemption does not apply to gains from the sale of real property.

[m] Treaty terminated January 1, 1988, except that the exemption from tax provided in Article VIII for certain interest will remain in force.

[n] The exemption applies only to interest on credits, loans, and other indebtedness connected with the financing of trade between the United States and the Union of Soviet Socialist Republics. It does not include interest from the conduct of a general banking business.

[o] The exemption applies only to gains from the sale or other disposition of property acquired by gift or inheritance.

[p] The exemption does not apply if the recipient was a resident of the United States when the pension was earned or when the annuity was purchased.

[q] Annuities paid in return for other than the recipient's personal services are exempt.

[r] Generally, if the property was owned by the Canadian resident on September 26, 1980, not as part of the business property of a permanent establishment or fixed base in the U.S., the taxable gain is limited to the appreciation after 1984. Capital gains on personal property not belonging to a permanent establishment or fixed base of the taxpayer in the U.S. are exempt.

[s] Under the treaty, the reduced rate for royalties with respect to tangible personal property is 7%.

[t] Does not include alimony; alimony is exempt.

[u] Withholding at 30% may not be required on the disposition of U.S. real property interests. See *U.S. Real Property Interest* earlier in this publication.

[v] Tax imposed on 70% of gross royalties for rentals of industrial, or scientific equipment.