[¶5014] INTRODUCING THE PORTFOLIO INTEREST EXEMPTION

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Until 1984, U.S. businesses wishing to tap international financial markets were obliged to use international finance subsidiaries. However, this was a cumbersome device that was not free from tax risks. The Tax Reform Act of 1984 (Title I of the 1984 Deficit Reduction Act) introduced the portfolio interest exemption.[i] This exemption was designed primarily to simplify U.S. companies' access to the international financial markets, which in 1984 still primarily meant the European markets in general and the London market in particular. In December 1986, the Treasury conceded that the exemption also applies to private credit transactions. Although temporary regulations implementing the exemption were first published as early as August1984, final regulations were not published until October 1997 at the same time that the IRS finalized a comprehensive revision of the regulations on withholding tax on payments to foreign persons.

Two parts. This analysis will describe the basic features of the exemption for portfolio interest. A second analysis at ¶5015 will examine the exceptions to the portfolio interest exemption (including the exclusion of contingent interest), discuss special rules in applying the exemption, and also provide planning tips when the conditions for the exemption cannot be readily met. To assist you, this analysis is divided into the following main topics:

1. Background ¶5014.1
2. Overview of the portfolio interest exemption ¶5014.2
3. Obligations in registered form ¶5014.3
4. Obligations in bearer form ¶5014.4
5. Withholding and Information Reporting ¶5014.4

[¶5014.1] BACKGROUND

The portfolio interest exemption did not spring fully clad and armed from the heads of the legislators. Rather, it resulted from the confluence of the general rules applicable to foreign investment in the United States, the historical development of the international financial markets, initially in Europe and later in Asia, the transformation of the United States into a major debtor nation and many years of budget deficits that came to an end only in 1999.

For 20 years, the U.S. regime for taxing interest paid to foreigners acted as an obstacle to foreign financing. Before the enactment of the portfolio interest exemption by the Tax Reform Act of 1984, the international finance subsidiary, described below, partially overcame the obstacle. The portfolio interest exemption was designed to remove the obstacle altogether, although not without requiring issuers willing to pilot through shoals of paperwork.

(1) History of the International Financial Markets

Early History. For many years after World War II, the United States exported capital to other nations and began to run heavy balance of payments deficits. As a result, a great number of dollars came to be held outside the United States, primarily in Europe. By the time of the 1967 devaluation of the pound sterling, the dollar had effectively replaced sterling as the world's reserve currency, and numerous transactions were conducted in dollars that had no connection at all with the United States. During the past 30 years, a financial market emerged in which these so-called Eurodollars were invested and traded. The market is now a

multicurrency market, with obligations denominated in dollars, yen, pounds sterling, Deutschmarks, Swiss francs, and other major currencies, as well as baskets such as the European currency unit (ECU) and, already, the new European currency, the Euro. It is also a global market, with major centers in London, New York and Tokyo and important regional centers in Hong Kong and various European cities.

Initially, the U.S. borrowers in the medium- and long-term market were confined to a relatively small number of blue chip industrial companies.[1] These borrowers grew in number during the 1960s, influenced by government programs designed to encourage overseas borrowing.[2]

Later, and especially over the last 15 years, the market widened significantly in scope and sophistication. The ultimate lenders consist primarily of numerous private investors as well as pension funds and other institutions. The requirements of private investors have shaped the market for longer-term obligations or Eurobonds. Investors are attracted to U.S. corporate issuers by the political stability of the United States. At the same time, however, they require complete nontaxability and a high level of confidentiality and liquidity. These investor concerns have in part been responsible for funds being available to borrowers at rates that have generally been lower than the prime rates of U.S. banks, but they have also meant that the typical Eurobond issue is structured as a bearer instrument designed to guarantee anonymity.

International financial markets today. Today, the international financial markets consist broadly of three overlapping segments:

! *Short-term market.* The first is a market in which banks and multinational enterprises place their funds on a short-term basis. Market operations are conducted primarily over the telephone with coded confirmations. This aspect of the market is not considered further in this analysis because it does not involve the application of the portfolio interest rules in any significant way.

! *Short- to medium-term market.* The second segment consists of a short- to-medium term market for the issuance by banks and large corporations of notes and other forms of corporate paper. This is typically accomplished through the creation of facilities by which a bank, or a syndicate of banks, agrees to place that paper in the market on a best efforts or fully

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1 According to Pergam, "Eurocurrency Financing: Legal Position of U.S. Corporate Issuers," *International Capital Markets and Securities Regulation*, ed. Bloomenthal (Clark Boardman 1982) at §9.01, note 1 [hereinafter cited as Pergam, Eurocurrency Financing], the first Eurobond issues by affiliates of U.S. companies were for Mobil Holdings S.A. (June 21, 1965), U.S. Rubber Uniroyal Holding S.A. (July 29, 1965) and Cynamid Development Corporation (September 10, 1965). The first convertible issue (in which the bonds of the finance subsidiary were convertible into stock of its U.S. parent) was a $25 million offering by Monsanto International Finance in October 1965. Kerr, *A History of the Eurobond Market - The First 21 Years* (Euromoney Publications 1984) at 22.

2 These included the Interest Equalization Tax, enacted by the Interest Equalization Tax Act, Pub. L. 88-563, 78 Stat. 809 (1964), codified at IRC §4911 et seq. of the Code (repealed by Sec. 1904(a)(21) of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1525, 1814) and the Foreign Direct Investment Program, 15 CFR §1000 et seq.

underwritten basis.[3] Borrowings by U.S. issuers are typically structured so as to take advantage of the withholding tax exemption for original issue discount (OID) on instruments with a maturity of 183 days or less, rather than the portfolio interest exemption.

! Medium- to long-term market. The third segment is a medium- to long-term market through which corporate borrowers syndicate--through underwritten private placements and public offerings--all types of debt instruments. These instruments can have fixed or variable interest rates or, in the case of zero-coupon bonds, can carry only OID. They can have rates constrained by caps and collars and they can be hedged through currency and interest swaps. They can have definite, variable, or perpetual terms. They can be denominated in any major convertible currency or baskets of currencies. They can have redemption features, convertibility, stock warrants (or other equity features), various forms of security, and numerous other attributes limited only, if at all, by the ingenuity of the corporate financiers and lawyers who put these transactions together.

Characteristically, investors in the third segment require a high degree of liquidity, security, and anonymity as well as no withholding taxes. In exchange, they generally have been willing to accept marginally lower rates of return. The market provides liquidity by means of a well developed secondary market, security by the quality of the borrowers, and anonymity by the extensive use both of instruments in bearer form and of nominee holders and custodians.

The U.S. government and numerous U.S. corporations routinely use the international financial markets to obtain financing and manage their treasury functions. In this process, the U.S. budgetary deficit acted as the push and lower rates as the pull. The political stability and economic power of the United States in turn acted as the lure for foreign holders of U.S. dollars. In the 1990s, the international financial markets have become very large, and are characterized by sophistication, accessibility, liquidity and global integration, so that speaking of separate U.S. and international markets may be misleading both for most U.S. financial institutions and medium and large U.S. corporations.

Today, the international financial markets operate virtually round the clock in the three major centers (Tokyo, London and New York), with financial institutions transferring their books of business from one center to the other as each opens for business. A good description of the operation of the modern market is contained in the Internal Revenue Service's notice on advanced pricing agreements relating to global trading of commodities and financial instruments:

> Four general functions are common to global trading operations; trading, sales, management, and support. A trader quotes prices, initiates buy and sell transactions, and determines whether and how to hedge transactions. A salesperson advises clients about ways to manage the price, interest rate, and currency exchange risks associated with their assets and liabilities, with a view toward selling them a derivative financial product or commodity. A manager controls or monitors the level of risk to which the institution is exposed and sets trading limits. Finally, the support function performs various wide-ranging

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[3] For a comprehensive description, see *Euronotes: RUFs, TRUFs, NIFs, SNIFs and BONUSes*, ed. Bankson and Lee (Euromoney Publications 1985) [hereinafter cited as Euronotes].

activities that assist the first three functions; including technology and information systems development and provision, credit analysis of customers and counterparties, accounting, contract administration, and coordination of the transportation and delivery of physical commodities.

Different companies have integrated these functions in varying degrees for a variety of business reasons. However, two broad types of organization can be distinguished: operations that are functionally fully integrated and those that are not.

Global trading operations of companies that are functionally fully integrated are characterized by the centralized management of risk and personnel. The business is managed as one global position for purposes of risk management rather than several discrete businesses. Thus, a trading book is not independently maintained for each trading location. Rather, one book is maintained and the trading authority for that book is "passed" from trading location to trading location at the close of each trading day for that trading location (the "global book"). To assist in the management of the risk, a central credit department monitors the credit-related exposure of the transactions entered into by the traders. This information is used by the home office to establish credit guidelines and customer credit limits to be applied by traders throughout the company. . .[4]

(2) U.S. Taxation of Interest Paid to Foreign Persons: 30% Flat-Rate Tax on Non-ECI

The United States imposes a tax at a flat rate of 30% on the gross amount of interest received by nonresident aliens and foreign corporations[5] from U.S. sources to the extent this interest is *not* income effectively connected with a U.S. trade or business (commonly referred to as ECI).[6] No deductions are permitted in calculating the amount subject to tax. Tax on this interest is collected primarily by requiring the borrower to deduct and withhold the tax and remit the amount withheld to the government, generally through the Federal Tax Deposit system.[7] As explained below, the tax and a modified form of withholding apply to OID.[8]

Exceptions. The 30% flat-rate tax is subject to a number of exceptions, some inherent in the statutory language defining the scope of the tax and others specifically set out in the statute.

Definitional limitations. To begin with, the tax does not apply to interest that is ECI. Instead, the *net* amount of ECI is subject to tax at regular U.S. rates under IRC §1 or §11, as well as to the alternative minimum tax.[9]

4 Notice 94-40, 1994-1 C.B. 351.

5 In the balance of this analysis, we will refer to nonresident aliens and foreign corporations as foreign persons.

6 IRC §871(a) and §881(a).

7 IRC §1441, § 1442; Reg. §1.6302-2, §1.1461-3(a)(2).

8 See text accompanying note et seq.

9 IRC §871(b), §882(a).

Second, the tax does not apply to interest unless it has a U.S. source and is paid to a foreign person. Essentially, interest has a U.S. source if the payor is a U.S. resident (as explained in greater detail in the endnote, the term "resident" is subject to some special definitional rules).[10]See also IRC §884(f)(1)(A) (certain interest paid by foreign corporations engaged in U.S. trade or business as if paid by domestic corporation).

Third, the tax does not apply to interest unless it is actually or constructively received.[11] Not only is the taxpayer effectively placed on the cash receipts method but other related features of U.S. tax law, such as those relating to the taxation of OID, below-market loans, and the deductibility of interest payments to related parties operate differently than they would in a purely domestic context.[12]

Statutory exemptions. In addition to definitional limitations on the scope of the tax, there are also various statutory exemptions from the 30% flat-rate tax:

! Interest paid on deposits by banks, savings and loan associations, and certain insurance companies.[13]

! Interest subject to the normal exclusion from gross income for certain municipal bonds.[14]

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[10] The detailed rules on source of interest income are found in IRC §861(a)(1)(A) and the definition of a U.S. resident are found in section 865(g). Note that interest paid by a U.S. citizen-resident abroad or a foreign branch of a U.S. bank generally has a foreign source. In a piece of drafting personally approved by the Red Queen, a resident alien with a "tax home" outside the United States is not a U.S. resident while a nonresident alien with a tax home in the United States is a U.S. resident. The expression "tax home" does not refer to whether the individual is resident in another country for its tax purposes. Instead, it refers to the place where the individual has his regular or, if more than one, his principal place of business. If the individual has no regular or principal place of business, then the expression refers to his principal abode. IRC §911(d)(3) and Treas. Reg. §1.911-2(b). For the antecedents of this method of drafting, see L. Carroll, Through the Looking Glass.

[11] Some IRS agents have been known to assert that payments have been made just because they were accrued on the books of the borrower, relying on Rev. Rul. 70-251, 1970-1 CB 183 and TAM 9252004. Both of these seem clearly to involve cases of constructive receipt, however.

[12] See, for example, IRC §871(a)(1)(C), §881(a)(3) (taxation of OID); Temp. Reg. §1.7872-5T(c)(2) (special rule for below-market loans involving foreign persons); IRC §163(e)(3) (deferral of OID deduction until paid when obligation is held by related foreign person); and IRC §267(a)(3) (regulatory authority to apply matching principal to payments to foreign persons) and Not. 89-84, 1989-2 CB 402.

[13] IRC §871(i), §881(c).

[14] IRC §103.

! OID for instruments with a maturity of 183 days or less.[15]

! Interest exempt (or entitled to a reduced rate of tax) under an income tax treaty to which the United States is a party.[16]

! Interest exempt under the special rules applicable to foreign governments and international organizations.[17]

! Interest paid by 80:20 companies.[18]

! Interest qualifying as "portfolio interest", the subject matter of this analysis.[19]

Finance subsidiary structure. Under the 30% withholding tax regime, U.S. issuers could not gain direct access to the Eurodollar market. Eurobonds invariably carry interest net of any withholding taxes so that, for example, to pay a 10% coupon net of withholding to an anonymous foreign bondholder, a U.S. issuer would have to pay a gross rate of just under 14.29%.[20] This would have driven up the cost well beyond rates available on the domestic market.[21]

Netherlands Antilles subsidiary. Over the years, however, there developed a fairly standardized international finance subsidiary structure designed to eliminate the withholding tax. Under this structure, a U.S. corporation would organize a Netherlands Antilles subsidiary, which would issue bonds guaranteed by the U.S. corporation (or a substantial affiliate). The subsidiary would then re-lend the proceeds to its parent or other group members. Under the "U.S.-Netherlands Antilles income tax treaty" (technically the 1948 U.S.-Netherlands income tax treaty as extended in 1955 to the Netherlands Antilles), the interest paid by the U.S. group to the finance subsidiary and the interest paid by the finance subsidiary to the bondholders was free of U.S. tax and withholding. Apart from transaction and corporate maintenance costs, the only cost was the Netherlands Antilles' requirement that the finance subsidiary pay a Netherlands Antilles profits tax at 24-30% on a 1% spread between the interest rate paid to the finance subsidiary and the rate paid to the bondholders. The 1% spread was subpart F income,

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15 IRC §871(g)(1)(B).

16 IRC §894.

17 IRC §892.

18 Interest is foreign source under IRC §861(a)(1)(A) if it meets the 80% foreign-business requirements of IRC §861(c)(1). For a further discussion, see ¶5015.3(1).

19 IRC §871(h), §882(c).

20 Also, Eurobonds frequently permit the issuer to prepay the bonds should they become subject to a withholding tax.

21 For example, the cost savings in 1983 were estimated to be as high as 119 basis points (1.19%). See Note, "The Repeal of the Thirty Percent Withholding Tax on Portfolio Interest Paid to Foreign Investors," 6 Northwestern Journal of Law and International Business 930, 931 note 3 (1984) [hereinafter cited as Northwestern Note].

but the profits tax on the spread was eligible for the deemed-paid foreign tax credit (FTC).[22]

Subsidiary structure challenged. The finance subsidiary structure theoretically was subject to various challenges. The principal one was that the subsidiary was a mere conduit that did not really receive the interest paid to it by its parent but merely acted as a paying agent for obligations that truly were owed directly by the parent to the bondholders. The IRS indeed began to assert those arguments in examinations in the early 1980s.[23] They were able to rely on *Aiken Industries*, a particularly egregious case in which a treaty protected company had been inserted into a structure with the sole purpose of acting as a conduit, as well as on the familiar *Plantation Patterns* case, which suggests that in some circumstances a loan to a subsidiary guaranteed by its parent is truly a loan to the parent.[24]

However, these challenges, whatever their technical merits, in reality stood little political chance of prevailing in the economic climate of the 1980s. The Netherlands Antilles finance subsidiary was not a tax plan implemented by a few aggressive tax planners for obscure audit lottery players. It began in response to the 1964 Interest Equalization Tax and, following a series of favorable IRS rulings,[25] soon became a widely used method for the major industrial and commercial corporations of the United States to borrow on the Eurocurrency market at rates more favorable than those prevailing in the United States.

Enactment of portfolio interest exemption. Proposals for repeal of the 30% withholding tax in the mid-1970s had met with a cool response but, as soon as the audits became public knowledge, activity to regularize access to the market intensified. Congress's response, in the Tax Reform Act of 1984, was to introduce the portfolio interest exemption -- designed to eliminate the need for Netherlands Antilles finance subsidiaries for issues made after July 18, 1984.

Exemption's legislative history. The 1984 changes resulted from a fairly arduous reconsideration of the U.S. taxation of interest paid to foreign persons. A series of bills were introduced in 1983 and 1984 before the current version of the provision was enacted.

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[22] IRC §902(a), §960(a). For a description of the international finance subsidiary, see Pergam, Eurocurrency Financing, at §9.03[1]-[3].

[23] According to one report, there were at least 25 such examinations in progress in 1983, with one company, Texas International, disclosing the examination in its annual proxy statement. See report in 46 Taxes International 13 (1983).

[24] *Aiken Industries*, 56 TC 925; *Plantation Patterns, Inc. v. Commr.* (CA-5, 1972), 29 AFTR2d 72-1408, 462 F.2d 712, *cert. denied*, 409 U.S. 1076 (1972). See also *Johannson v. U.S.*, (CA-5, 1964), 14 AFTR2d 5605, 336 F.2d 809. Compare *Perry R. Bass*, 50 TC 595 (when use of Swiss company was held to have a business purpose).

[25] Interest Equalization Tax Act, Pub. L. 88-563, 78 Stat. 809; Rev. Ruls. 69-377, 1969-2 CB 231, 69-501, 1969-2 CB 233, 70-645, 1970-2 CB 273, 72-416, 1972-2 CB 591, and 73-110, 1973-1 CB 454. When the Interest Equalization Tax rate was reduced to zero, these rulings were all revoked by Rev. Rul. 74-464, 1974-2 CB 46, *modified by* Rev. Rul. 77-178, 1977-1 CB 43. The rulings continue to be cited by Congress in determining what is an acceptable debt to equity ratio for a finance subsidiary. See, for example, Tax Reform Act of 1984, Sec. 127(g)(3)(B) (grandfathering existing U.S. owned finance subsidiaries), described in ¶5015.2.

H.R. 3025. One version of the proposed exemption was H.R. 3025, sponsored by Representatives Gibbons and Conable, which would have simply repealed the withholding tax on any debt obligation that was either in registered form or was a bearer obligation targeted to foreign markets and on which the interest was payable outside the United States and its possessions.[26] This bill would have also permitted U.S. issuers to assume debt obligations of their international finance subsidiaries.

H.R. 2163 and H.R. 4029. The Senate amendment to H.R. 2163, responding to concerns that immediate repeal of the tax would especially harm the Netherlands Antilles' economy if it applied to pre-existing obligations, would have phased out the tax over four years. A third approach, tried by H.R. 4029 sponsored by Representative Barnard, would have repealed the tax only for Eurobonds, making no provision for registered obligations and also excluding obligations of the United States and its agencies. All these proposals would have preserved the tax in a number of specified circumstances, in particular when the lender was a related party of the borrower or a foreign bank. The compromise reached by the Conference Committee resulted in a relatively broad exemption primarily along the lines of the Gibbons-Conable proposal.

Pre-7/19/84 loans excluded. However, the *status quo* was preserved for pre-July 19, 1984, loans by applying the exemption only to issues made after that date. This was achieved by providing an anti-churning rule to discourage repayment of existing structures and replacing them with issues under the new rules and by grandfathering existing issues through finance subsidiaries. The purpose was to preserve for the Netherlands Antilles the substantial income it was deriving from existing issues while giving it time to adjust to the eventual elimination of that income as the issues matured in the ordinary course.

Bearer bonds and back-up withholding. One other series of developments has significantly affected the shape of the portfolio interest legislation. To limit opportunities for U.S. residents to avoid tax on interest payments, Congress in the early 1980s passed several rules designed to penalize issuances of bearer bonds and to impose a 10% withholding requirement on payments of interest and dividends to U.S. persons.[27] The latter requirement met with fierce opposition from the banks and other financial institutions charged with its implementation and in 1983 was repealed retroactively and replaced by a system of back-up withholding and information reporting (coupled with enhanced computerized matching by the IRS of the reports with returns of the taxpayers in question).[28] As this analysis show, the rules

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[26] A similar measure, S. 1557, was sponsored by Senators Chafee and Bentsen, but it would not have preserved the tax for obligations issued by the United States or its agencies. There was some concern that the entry of the United States as a major issuer on the Eurobond market would cause rates to increase because of the increased competition for funds.

[27] The sanctions include denial to the issuer of an interest deduction (IRC §163(f)) or an earnings and profits adjustment (IRC §312(m)); the imposition of an excise tax on the issuer (IRC §4701); ordinary income treatment on gains (IRC §1287); and denial of losses to the holder (IRC §165(j)). The 10% withholding tax was imposed by IRC §3451 et seq., enacted by Sec. 301 of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 324 (hereinafter cited as TEFRA) and repealed in 1983 retroactive to its inception, as described below.

[28] IRC §3406, enacted by the Interest and Dividend Tax Compliance Act of 1983, Pub. L.

relating to bearer bonds and back-up withholding have had a significant impact on the portfolio interest exemption in practice and account for an additional layer of complexity.

[¶5014.2] OVERVIEW OF THE PORTFOLIO INTEREST EXEMPTION

(1) Statutory Requirements

IRC §871(h) and §881(c), enacted by Sec. 127(a) of the Tax Reform Act of 1984, provide that, in the case of portfolio interest, the 30% withholding tax on interest and as applicable to OID is not imposed on foreign persons.

Portfolio interest is defined as interest otherwise subject to the withholding tax on any obligation that is either (1) not in registered form if it meets the foreign-targeted obligation requirements of IRC §163(f)(2)(B) or (2) in registered form if the withholding agent receives an appropriate statement that the beneficial owner of the obligation is not a U.S. person.[29] The statement can be made either by the beneficial owner or by a securities clearing organization, a bank, or another financial institution that holds customers' securities in the ordinary course of business.

The exemption does not apply in a number of specified cases:

! Interest received by a "10-percent shareholder". In the case of a corporate issuer, this means the holder of 10% or more of the combined voting power of the issuer. For an issuer that is a partnership, it means any person holding a capital or profits interest of 10% or more. Modified attribution rules apply under IRC §318(a) in determining ownership of stock and regulatory authority is provided to the Treasury to apply and develop comparable attribution rules for partnerships.

! Interest paid on an obligation issued after April 7, 1993 (except pursuant to a binding written contract entered into on or before that date) where the interest is contingent in one of a number of ways.

! Interest paid to a controlled foreign corporation (CFC) by a related person.

! Interest received by a banking corporation on an extension of credit made under a loan agreement entered into in the ordinary course of its trade or business.

! Interest paid on an obligation issued before July 19, 1984.

! Interest paid to residents of a country if the Treasury has determined that the exchange of information with that country is inadequate to prevent tax evasion by U.S. persons, but only for obligations issued after the date the determination is published.

These exceptions are discussed in greater detail in Part Two of this analysis at ¶5015.

>>>>IMPORTANT POINT>>>The portfolio interest exemption is an exemption from

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98-67, 97 Stat. 369.

[29] This analysis does not cover the question of who is a withholding agent. *See* Treas. Reg. §1.1441-7 for the definition of withholding agent under the new withholding tax regulations. For a detailed discussion of prior law and of a number of concepts that remain relevant, *see* Dale, "Withholding Tax on Payments to Foreign Persons," 36 Tax Law Review 49 (1980) at 63 and Karlin, Sczudlo, Wisialowski and Darcy, "Duty Through the Eye of the Withholder" 70 TAXES - The Tax Magazine 492 (1992).

the 30% flat-rate tax. It is not an exemption from the tax on income effectively connected with a U.S. trade or business nor, in the case of a treaty resident, does it exempt business profits (or industrial and commercial profits) attributable to a U.S. permanent establishment that are permitted to be taxed by the treaty.

(2) Regulatory Requirements

With commendable speed, the Treasury issued the first sets of temporary regulations concerning the portfolio interest exemption on August 22, 1984, less than a month after passage of the Tax Reform Act of 1984. The regulations were not finalized until October 6, 1997, with an effective date for payment made after December 31, 1999.[30]

Reg. 1.871-14(b)(2) and (c)(4). These regulations primarily explain the relationship of the portfolio interest exemption to the back-up withholding and information reporting rules. Various aspects have been controversial, but the relationship of the market and the IRS with regard to the exemption has stabilized and the final regulations make minimal substantive changes from the temporary regulations.

Other regulations. Various other regulations bear directly on the exemption. These include Reg. §1.871-14(e), which deals with the application of back-up withholding in various transnational contexts; Reg. §1.163-5(c), dealing with registration-required obligations; and both Temp. Reg. §5f.103-1(c) and Reg. §1.871-14(c)(1)(i), defining the term "registered form." These regulations have now been consolidated in the final regulations and will be examined in greater detail below.

Application to nonpublic obligations. Initially, the temporary regulations also defined portfolio interest so as to exclude interest paid for instruments that are not registration-required obligations, as defined in IRC §163(f)(2)(A), other than those exempted from the registration requirement under the exception for the foreign-targeted obligations. In other words, interest did not qualify as portfolio interest if paid on (1) instruments issued by a natural person, (2) instruments "not of a type offered to the public," and (3) instruments having a maturity at issue of one year or less.

The Treasury justified this exclusion on the grounds that the policy basis for the repeal did not apply to the excluded obligations (in particular trade receivables and private debt), which unlike public trade debt, are not actively traded in a secondary market demanding tax exemption irrespective of the identity of the holder (other than a U.S. person). The Treasury also argued that other countries had similarly limited their exemption and failure to limit it would unilaterally deprive the Treasury of a bargaining chip in treaty negotiations.

These arguments were controversial, especially because the plain words of the statute simply did not support the Treasury's position. Eventually, on December 17, 1986, the Treasury reversed itself and issued regulations that track the statute. Thus, the portfolio interest exemption can apply to obligations in the three previously excluded categories.[31]

(3) Definition of Interest

What constitutes interest?[32] Interest is usually defined as compensation for the use of

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[30] Treas. Reg. §1.871-14(h), T.D. 8734 (Oct. 6, 1997); Notice 98-16, 1998-15 IRB1.

[31] For an early history through mid-1985 of objections to the Treasury's position, including the Treasury's unsuccessful effort to secure a technical correction confirming its early interpretation, see Northwestern Note, at 957-962.

[32] See, generally, Plumb, "The Federal Income Tax Significance of Corporate Debt: A

another's money. Interest therefore includes OID. This analysis does not consider in detail the question of what constitutes interest. The Code generally does not contain any special definition of interest for purposes of the 30% tax or any exceptions to it, and, therefore, the tax and exceptions are applied to any amount which constitutes interest for the general purposes of the Code.[33]

Original Issue Discount. OID is often found in transactions calling for payments not designated by the parties as interest, such as a portion of an installment payment of purchase price if the parties do not explicitly state an adequate rate of interest or interest imputed under the below-market loan rules. For example, if a parent makes an interest-free loan to a child, the transaction may be recharacterized as a loan of a lower amount carrying OID and the difference between the amount actually lent and the lower amount is treated as an outright gift.

For most purposes, interest and OID are treated similarly and, as discussed below, the exemptions from the tax and withholding, including the portfolio interest exemption, are applicable to OID. In the case of OID, there are some differences in timing and applying withholding requirements.[34]

Except for short-term OID, which is exempt from the 30% tax as explained above, OID is subject to the 30% tax. The tax is imposed on receipt of the OID (as it is on the receipt of interest), but it is also imposed whenever a payment of any kind is made under the instrument to the extent of OID accrued prior to the payment date and not previously taken into account. Withholding is required whenever such a payment is made. The amount of tax and withholding cannot exceed the amount of the payment and is further reduced by any tax imposed on the payment itself.

> **Example.** On January 1, 1999, F, a foreign person, purchases at issuance from D, a domestic corporation, a two-year bond with a face value of \$110.25 for a price of 100 (equivalent to a 5% yield) and interest at a further 2% payable annually on the issue price. The OID is \$10.25, of which \$5.00 accrues in 1999 and \$5.25 accrues in 2000. On December 31, 1999, D pays \$2 in interest. Tax on the interest is \$0.60 (30% x \$2). This leaves \$1.40. OID accrued since issuance is \$5, on which the tax is \$1.50. The \$1.40 payment left after tax on the \$2 interest payment must be paid as tax on the accrued

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Critical Analysis and a Proposal," 26 Tax Law Review 369 (1971); Dale, Withholding Tax, at 71; *Plantation Patterns, Inc. v. Commr.*, 462 F.2d 712 (CA-5, 1917), cert. denied 409 U.S. 1076 (1972); see also IRC §385.

[33] Similarly, interest for the purposes of income tax treaties is generally defined under the law of the jurisdiction seeking to impose the tax. However, treaty exemptions and rate reductions do not apply to all forms of interest. Our older treaties somewhat disallowed rate reductions for interest on obligations secured by mortgages of real property, but virtually all of these have now been modernized. Compare, for example, U.S.-Austria income tax treaty of 1957, art. VIII with U.S.-Austria income tax treaty of 1996 (entered into force Feb. 1, 1998), art. II. Our newest treaties also permit the United States to treat as dividends participation payments which for domestic purposes are interest. Ibid., art. 10(3); see also U.S.-Netherlands income tax treaty, art. 10 para. 4.

[34] IRC §871(a)(1)(C) and §881(a)(3).

OID; $0.10 of the tax is deferred because the amount of tax cannot exceed the net amount of the payment. In effect, $4.67 of OID has been taken into account ($1.40/30%) and $0.33 (0.10/30%) has not.

On December 31, 2000, D pays off the bond. F is entitled to $110.25 plus another $2 in interest. Tax on the interest is $0.60. The OID is $10.25 less the $4.67 in OID previously taken into account, or $5.58. Tax on $5.58 at 30% is $1.67. The total tax over the lifetime of the bond is $4.27 ($0.60 + 1.40 + 0.60 + 1.67). By way of comparison, if the bond had simply yielded 7% in interest each year, the tax would have been $2.10 each year, for a total of $4.20. The $0.07 difference is accounted for by the compounding of interest because D did not pay 5% out of the total yield until maturity and that 5% itself yielded an additional $0.25 (30% of which is $0.07).

In addition to requiring that tax be paid on accrued OID whenever a payment is made under the obligation that yields OID, tax is also imposed when the holder of the obligation sells it with accrued OID. The 30% tax is charged on the amount of the gain or the amount of OID not previously taken into account, whichever is less.

Example. Suppose, in the preceding example that, on December 30, 1999 F sold the bond. Because of a drop in interest rates, he receives only $106. Under standard assignment of income principles, the $2 interest F was due to receive the next day would be treated as F's income and $2 out of the purchase price would be treated as payment for the right to receive such interest. (Although F would be taxable, the 1997 regulations (like their predecessor) do not require the buyer to withhold on the $2.[35]) F would therefore have a gain on the sale of the bond of $4. OID accrued since the issuance of the bond is $5 (no amount of OID previously having been taken into account). The tax would be $1.20, which is 30% of the lesser of the gain, $4, and the accrued OID, $5.

Market Discount. IRC §1276(a)(4), which treats market discount as interest, by its own terms does not apply for purposes of the 30% flat-rate tax or withholding. Therefore, market discount in the hands of a foreign seller of a bond will be treated as interest only if it is taxable as ECI. Otherwise, it will be a capital gain to the foreign seller and entitled to the exemption from tax generally applicable to non-ECI gains of foreign persons.

Leasing Transactions. Rental payments for the use of property may be treated as interest for income tax purposes if the substance of the transaction is a secured loan or conditional purchase. Such a lease is usually referred to as a finance lease, to be distinguished from a "true" lease (also referred to as an "operating lease"). Although the form of the transaction may refer to rental or lease payments, the portfolio interest exemption can apply to the interest component if the substance is a finance lease. The lease has to specify that the lessor's rights can only be transferred in accordance with the registered form requirements and a Form W-8 or substitute must be provided; Alternatively, (although the author has not encountered this in practice) the lessor's interest could perhaps be tortured into compliance with the foreign targeted bearer obligation rules.[36]

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[35] Tres. Reg. §1.1441-3(b)(2)(i).

[36] For an example where the Service assumed, without discussion, that a lease could be treated as a portfolio interest qualified loan, see Ltr. Rul. 9822007 (Feb. 10, 1998).

Notional Principal Contracts. Income from notional principal contracts, even those involving interest swaps (as opposed to currency, equity, or commodities swaps) is not treated as interest. The Service has promulgated a separate set of regulations dealing with swaps under which that income is sourced according to the residence of the taxpayer or, under certain circumstances, the residence of a taxpayer's qualified business unit (a foreign bank branch, for example). If, however, the income is effectively connected with a U.S. trade or business, the income is sourced in the United States.[37]

The IRS previously ruled that swap payments in an interest swap derived in the conduct of an active trade or business are treated as "business profits" for treaty purposes and therefore in the hands of a foreign person are eligible for the treaty exemption for business profits of a treaty country resident not having a U.S. permanent establishment.[38] The ruling has not been superseded by the regulations.

Securities Lending Transactions and Sale-Repurchase Agreements. At the same time as it issued final regulations under section 1441, the IRS also finalized regulations proposed in 1992 on the treatment of securities lending transactions. The final regulations add rules on the source and character of income streams from such transactions and explain how treaties and the portfolio interest exemptions will apply.[39]

A securities lending transaction is defined as a transfer of securities described in section 1058 or a "substantially similar transaction". Section 1058 in turn requires an agreement containing four elements:

(1) The agreement must provide for return of identical securities.

(2) It must provide for the transferor to receive amounts equivalent to all interest, dividends and other distributions to which the owner is entitled during the period of the loan.

(3) The agreement must not reduce the transferor's risk of loss or opportunity for gain from the securities.

(4) The agreement must also meet additional regulatory requirements, if prescribed.

To date, no such requirements have been promulgated or even proposed.

The scope of the reference to a "substantially similar transaction" is not immediately obvious. The final regulations refer separately to sale-repurchase transactions in response to public comment that it was not clear whether a sale-repurchase transaction is substantially similar to a securities lending transaction under section 1058. A sale-repurchase transaction (popularly referred to as a "repo") is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash. Beyond this, it is not clear whether a transaction that does not meet the strict criteria of section 1058 will be covered.

A securities lending transaction and a repo can generate substitute interest payments or substitute dividend payments, depending on the nature of the underlying securities. A substitute interest payment is defined as a payment to the transferor in a

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[37] Reg. §1.863-7 (1991).

[38] Rev. Rul. 87-5, 1987-1 CB 180.

[39] T.D. 8735, 62 FR 53498 (Oct. 14, 1997), adding §§1.861-2(a)(7), 1.861-3(c)(6), 1.871-7(b)(2) and 1.894-1(c).

securities lending transaction or a repo of an amount equivalent to an interest payment which the owner of the transferred security is entitled to receive during the term of the transaction. Similarly, a substitute dividend payment is a payment to the transferor in a securities lending transaction or a sale-repurchase transaction of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction.

The final regulations source and characterize substitute interest payments in the same manner as interest accruing on the transferred security[40] and source and characterize substitute dividend payments in the same manner as distributions with respect to the transferred security.[41]

The sourcing rules in the final regulations apply to both U.S. and foreign transferors. However, the characterization rule applies only for purposes of taxing foreign persons; it does not apply for any other purposes, such as to characterize U.S. source income that either belongs to a U.S. person or is effectively connected with a U.S. trade or business. Such income continues to be governed by prior law.[42] The final regulations make clear that income characterized as interest or a dividend is eligible for treaty relief.[43] In addition, substitute interest may qualify as portfolio interest if interest on the security would be eligible for the exemption and, in the case of interest on an obligation in registered form, the foreign transferor (lender) provides to the U.S. transferee (borrower) an IRS Form W-8 or substitute (or otherwise complies with the new documentation requirements described below).[44]

[¶5014.3] OBLIGATIONS IN REGISTERED FORM

This portion of the analysis considers the requirements applicable to instruments in registered form. These requirements include how an instrument is put into registered form and the information and certification requirements currently applicable to those instruments.

(1) Use of Registered Form

By far the largest category of registered obligations held by foreign persons are those issued or guaranteed by the United States, U.S. government-owned agencies, or various U.S. government-sponsored enterprises. The Treasury announced in August 1984 that it did not intend to issue bearer obligations, and it also indicated that it would

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[40] Treas. Reg. §§1.861-2(a)(7), 1.864- 5(b)(2)(iii), 1.871-7(b)(2) (first sentence) and 1.881-2(b)(2) (first sentence).

[41] Treas. Reg. §§1.861-3(a)(6), 1.864- 5(b)(2)(iii), 1.871-7(b)(2) (second sentence) and 1.881-2(b)(2) (second sentence).

[42] The Supplementary Information in T.D. 8735 gives as examples Rev. Rul. 60-177 (1960-1 C.B. 9), (substitute payments are ineligible for the dividends received deduction under IRC §243); Rev. Rul. 80-135, 1980-1 C.B. 18, (substitute payments are ineligible for the tax-exemption on state and local bonds under section 103).

[43] Treas. Reg. §1.894-1(c)

[44] Treas. Reg. §§1.871-7(b)(2) and 1.881-2(b)(2).

not permit these agencies to do so either.[45]

Soon afterwards, the Treasury announced that it would not permit the portfolio interest exemption to apply to bearer securities secured by Treasury obligations, at least if the repackaging occurred either in connection with the original issuance of the securities or at any time when the issuer was a U.S. person or a subsidiary of that person.[46]

Also, because of the sanctions imposed by the 1982 Tax Equity and Fiscal Responsibility Act and the 1983 Interest and Dividend Compliance Act, registration is virtually mandatory for public issues of debt obligations not targeted at foreign markets.

Finally, in the case of private transactions with foreign lenders, registered form obligations are generally the most practical alternative.

>>>>KEEP IN MIND>>>The purpose of the registration requirement is to ensure that the issuer knows the identity of the holder of the instrument. This enables the issuer to withhold the 31% back-up withholding tax if the holder is a U.S. person who has not furnished a taxpayer identification number (TIN). It also enables the issuer to furnish the appropriate reports to the IRS regarding interest payments made to U.S. persons who do supply TINs and to foreign persons generally.

(2) Registered Form Defined

The definition of registered form used for portfolio interest exemption purposes is contained in the final portfolio regulations in Treas. Reg. §1.871-14(c)(1), which states that the conditions for an obligation to be considered to be in registered form are the same as those described in Temp. Reg. §5f.103-1(c)(1) and, for ease of reference, the final regulation restates the temporary regulation.[47] It states that an obligation will be in registered form if

! the obligation is registered as to principal and interest with the issuer or its

[45] These enterprises include the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Banks, Federal Loan Mortgage Corporation (Freddie Mac), the Farm Credit Administration, and the Student Loan Marketing Association. See Supplementary Information to TD 7965 (August 22, 1984), amending the definition in the temporary regulations under IRC §163(f) of registration-required obligations for purposes of the various sanctions on issuers and holders of registration-required obligations not in registered form, which were issued along with the initial set of regulations relating to the portfolio interest exemption.

[46] Treas. Rel. R-2835 (September 1, 1984); Treas. Rel. R-2847 (September 7, 1984).

[47] The final regulation is an improvement because the Code itself makes locating the correct definition quite awkward. IRC §871(h)(7) states, somewhat unhelpfully, that the term "registered form" has the same meaning given to that term by IRC §163(f). This is unhelpful because, apart from a cryptic cross-reference to IRC §149(a)(3) (and formerly to IRC §103(j)), neither IRC §163(f) nor the regulations under that section gives any definition or other clue as to the meaning of the term. For the history of Temp. Reg. §5f.103-1, see TD 7852, 1982-2 CB 47, as amended by TD 7967, 1984-2 CB 329 and TD 8111, 1987-1 CB 69.

agent, and transfer of the obligation can be effected only by surrender of the old instrument and either the reissuance of the old instrument or issuance of a new instrument to the holder;

! the right to the principal of, and stated interest on, the obligation can be transferred only through a book entry system maintained by the issuer (or its agent); or

! the obligation is registered as to principal and interest with the issuer or its agent and can be transferred through both surrender and issuance (or reissuance) and the book entry system.[48]

Although the regulations do not further explain what constitutes registration, in practice this means that the issuer must maintain a written record of ownership of the obligation and the holder is identified in the certificate, promissory note, or other document issued to him to evidence the obligation.

The regulations explain that a book entry is a record of ownership that identifies the owner of an interest in an obligation. In effect, a book entry system requires maintenance of records in much the same manner as a stock register. The regulations further provide that an obligation will be considered to be transferable through a book entry system if the ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued.[49] This is an important clarification in a world in which, increasingly, paper certificates are no longer issued.

Temp. Reg. §5f.103-1(e) (and, post-1999, Reg.§1.871-14(c)) impose additional requirements on post-January 20, 1987, instruments designed to disqualify instruments that are convertible into bearer instruments at any time before maturity. However, an instrument not in registered form that is convertible at some future time into one that will remain in registered form until maturity will be treated after conversion as being in registered form.[50] In short, a registered form instrument is disqualified by being convertible to bearer form but a bearer instrument can be convertible into registered form and will be treated as such until permanently converted.

>>>>PRACTICAL SUGGESTION>>>Traditional forms of promissory notes will not meet the registered form requirement unless

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[48] The text reflects the 1986 amendments made by TD 8111, 1987-1 CB 69, which are effective for obligations issued after January 20, 1987, under a binding obligation entered into after that date. Temp. Reg. §5f.103-1(e)(1) and Treas. Reg. §1.871-14(c)(1)(i) make it clear that, for these obligations, compliance with the rules described in the text is the only method of meeting the registered form requirement. For the rules effective between July 19, 1984, and January 20, 1987, see Temp. Reg. §5f.103-1(c). For earlier instruments, the prior regulations specifically required that the instrument be registered with (or that the book entry system be maintained by) the issuer or its agent. Also, the prior regulations did not provide that instruments registered as to both principal and stated interest could be transferred through both the surrender and reissuance method and a book entry system.

[49] Temp. Reg. §5f.103-1(c)(2); Reg . §1.871-14(c)(1)(i)(B).

[50] Temp. Reg. §5f.103-1(e)(3); Reg. §1.871-14(c)(1)(i).

specially modified. The note generally does not require that the maker (issuer) maintain a book entry system. If a promissory note is governed by the Uniform Commercial Code (U.C.C.) as in effect in New York, California, and most other states (or, indeed, the negotiable instruments laws in effect in England and other foreign countries), it will be payable either to bearer or to an identified payee. In the latter case, the note is transferred by endorsement and delivery to the transferee. It can be endorsed in blank, whereon it becomes, to all intents and purposes, a bearer instrument.[51] Thus, the traditional form of a promissory note is a convertible instrument. When a promissory note is used, it is advisable to provide for transfer to be effective either exclusively on surrender and reissuance (duly endorsed by the maker) or, in some cases involving large numbers of notes, through a book entry system operated by the issuer or an issuer's agent acceptable to the holder. The issuer should be required to maintain a written register of ownership of the note. As an additional precaution, the note should also specifically provide that it cannot be endorsed to the bearer. A note containing these provisions probably ceases to be negotiable (that is, a transferee takes subject to defenses against the issuer and prior holders). The Service's agreement with this analysis was recently confirmed by a recently released Field Service Advice, in which a note included language indicating that the note could only be transferred by surrender and reissuance.[52] The note was, however, made payable "to the order of" the lender and the National Office advised the agent that this caused some ambiguity about whether the note could be endorsed in blank. Noting that the U.C.C. construes ambiguity in favor of negotiability, the Service found the note to fail the requirement that the obligation not be transferable to bearer. This is a harsh result when the intentions of the parties to comply with the registered form rules are manifest.

The second part of this analysis considers the application of the registered form rules in the context of obligations not in registered form that are held by passthrough entities (investment trusts, partnerships, REITs and so on) interests in which (shares, partnership interests, trust certificates, etc.) are actually or effectively in registered form. The results are not consistent, with the exemption being available for holders of registered interests in properly structured investment trusts and REITs but not for holders of registered interests in partnerships.

(3) Certification Requirements

[51] New York U.C.C. §3-202 (McKinney); California U.C.C. §3202 (West); cf. Bills of Exchange Act, 1882, 45 & 46 Vict. c.61 (England), §31.

[52] FSA 1998-376 (released Aug. 10, 1992).

In addition, for the exemption to apply to interest received by a foreign holder of an obligation in registered form, the withholding agent[53] must receive a statement meeting prescribed requirements that the beneficial owner of the obligation is not a U.S. person.

The Code provides that the statement can be made by the beneficial owner or by a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its business.[54] The final regulations, in coordination with the final regulations under section 1441, provide that a statement meets the statutory requirements in one of the methods summarized below:

Statement by beneficial owner. A U.S. person or an authorized foreign person[55] is treated as having received a statement meeting the statutory requirements if it can "reliably associate the payment with documentation on which it can rely to treat the payment as made to a foreign beneficial owner." The documentation in question is a written statement by the beneficial owner made to the withholding agent on Form W-8 (Certificate of Foreign Status), or a substantially similar form.[56] The statement must be prepared, renewed, and retained under the procedures applicable under Reg. §1.1441-1(e)(2)(ii) and (4). These regulations require the statement on Form W-8 (or a substitute) to be received in the calendar year the interest payment is made or collected or in either of the preceding two calendar years. The payor can, if it wishes, require the statement from the payee each time a payment is made. The payor must retain the statement for four years following the end of the last calendar year the statement is relied on. The payee must notify the payor of any change in residence or citizenship within 30 days following the change of status.

> **>>>>RESIDENCE PROBLEM>>>**Under the rules defining residence under IRC §7701(b), an alien can become a tax resident retroactively as far back as the beginning of the calendar year. This would be the result if he or she stayed in the United States for more than the number of days needed for him or her to be a resident under the substantial presence test.[57] As a practical matter, the rules

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[53] As used in this analysis, the term "withholding agent" refers to any person who is required to deduct and withhold tax under IRC §1441(a) or 1442(a) or who would otherwise be required to withhold but for an exemption. For a more comprehensive definition of the term, see Reg. §1.1441-7(a).

[54] IRC §871(h)(2)(B)(ii) and §881(c)(2)(B)(ii) impose the requirement. The statement is described in IRC §871(h)(5).

[55] Under the final withholding regulations, an authorized foreign agent is defined as an agent of the U.S. person with whom there is a written agreement, who has been identified to the IRS by the U.S. person as an authorized foreign agent, whose books and records and relevant personnel are available (on a continuous basis, including after termination of the relationship) for examination by the IRS in order to evaluate the withholding agent's compliance and for whom the U.S. withholding agent remains fully liable for the acts of its agent without the normal defenses available to principals for the wrongdoing of their agents. Reg. §1.1441- 7(c)(2).

[56] Reg. §1.871-14(c), which cross refers to Reg. §1.1441-1(e)(1)(ii) which in turn cross-refers to Reg. §1.1441-1(e)(2)(ii).

[57] IRC §7701(b)(3); Reg. §301.7701(b)-1(c). Similar problems can arise when aliens make

should be interpreted to mean that the IRS must be notified of the change in status within 30 days after the day of presence that caused the individual to meet the substantial presence test. There is no authority for this, however, beyond common sense.

Statement by financial institution. The U.S. person or authorized foreign person can also rely on a statement from:

- A person claiming to be "withholding foreign partnership"
- A person representing to be "qualified intermediary".
- A person claiming to be a U.S. branch of a foreign bank or insurance company.

In the case of payments in these three categories, the person to whom the payment is made must in turn be able to reliably associate the payment with documentation on which it can rely to treat the payment as made a foreign beneficial owner.

- A securities clearing organization, bank, or other financial institution. No particular form is required, but the certificate must contain a statement under penalties of perjury that the institution has received either a Form W-8 or an acceptable substitute from the beneficial owner or a similar statement from another financial institution. The regulations permit a chain of these certificates until some institution is able to certify that it actually holds the Form W-8.

Each certificate must give the name and address of the beneficial owner and be accompanied by a copy of the Form W-8. (The first of these requirements appears redundant, because the Form W-8 itself must set out the name and address of the beneficial owner.) The certificate must be prepared, retained, and renewed under the same conditions as a Form W-8, with the additional requirement that each financial institution promptly notify the next link in the chain if there is any change in the information or it has actual knowledge that the certificate is or has become false.

Certification for foreign-targeted obligations. The above requirements are quite burdensome for publicly traded obligations issued on the domestic market. They would be virtually compliance-proof with issues targeted at the foreign market.

As noted above, the largest category of foreign-targeted obligations in registered form are U.S. government issues. Because the United States has already, somewhat moralistically, deprived itself of the opportunity to obtain the slightly lower rates available by issuing debt in bearer form, the regulations reduce the burden on foreign-targeted obligations in registered form. However, the Treasury itself does not avail itself of this form of offering, although it is understood that some use of this category is made by the Student Loan Marketing Association.

General requirements. Under the regulations, a substitute form of certification may be used for registered obligations that are targeted to foreign markets. The rules are somewhat elaborate and reference is made to the regulations themselves for complete details, but they can be summarized as follows:

- A registered obligation is foreign-targeted if issued only to foreign persons (or foreign branches of U.S. securities clearing organizations, banks, or financial institutions that hold customers' securities in the ordinary course of business) under the same procedures described below applicable to the foreign targeting of bearer obligations. These procedures are modified somewhat if the obligation is issued by public auction (a common procedure for the sale of

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elections under IRC §6013(g) or (h) to be treated as U.S. residents.

Treasury bonds).[58]

! The interest must be paid to the registered owner at an address outside the United States, and the withholding agent must not have actual knowledge that the beneficial owner of the obligation is a U.S. person.[59]

! The withholding agent must receive either a certificate or statement from the payee.[60] There are two possibilities:

(1) If the payee is a financial institution or a member of a clearing organization, the payee must certify that all the interest on an identified obligation has been, since the previous certificate, and will in the future be received for the account of foreign beneficial owners or other institutions who had provided like certificates.[61] The certificate must be provided for the first time not more than 90 days before the payment due date--but the withholding agent can deduct and withhold at its option if the certificate is provided less than 30 days before the payment due date. Otherwise, the certificate must be provided between January 15 and January 31 of each year and is valid for the calendar year in which it is filed.[62]

(2) If the payee is the beneficial owner, then the beneficial owner must provide a Form W-8 (or substitute) stating that the payee is not a foreign person.

Additional requirements. Further detailed requirements are imposed when one of these obligations is acquired by a U.S. person as beneficial owner to ensure compliance with the requirements for filing a Form W-9 (Request for Taxpayer Identification Number and Certification) and otherwise dealing with back-up withholding and information requirements. If these requirements are complied with, then no withholding is required under IRC §1441 or 1442 (because the payee is not a foreign person) or under the back-up withholding rules. If they are not complied with, 30% withholding is required.[63]

The importance of statements and certificates. For obligations in registered form, statements and certificates play a critical role in the workings of the exemption. The regulations make no provision for curing defective or missing certificates or for substantial good faith compliance efforts. The final regulations facilitate compliance for the owner of the interest.

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[58] The foreign-targeting requirements for bearer obligations are considered at ¶5014.4(2). The two special rules applicable to offers by auction are (1) the issue need not be offered for sale or resale in connection with its original issuance only outside the United States and (2) an obligation put in registered form by means of a book entry system is not subject to the requirement of delivery of the certificate outside the United States. However, if evidenced by a physical document, other than a confirmation receipt, it must be legended to state that it has been issued or resold under the foreign-targeting procedures. Reg. §1.871-14(e)(2).

[59] Reg. §1.871-14(e)(1).

[60] Reg. §1.871-14(e)(1)-(3).

[61] Reg. §1.871-14(e)(3)(i).

[62] Reg. §1.871-14(e)(4)(i)(A).

[63] Reg. §1.871-14(e)(4)(i)(D).

The regulations provide that the portfolio interest exemption does not apply if the statement or chain of certificates is not provided before the expiration of the beneficial owner's period of limitation for claiming a refund of tax with respect to such interest.[64]

Nevertheless, unlike in the case of, for example, a treaty exemption, a foreign payee cannot get a refund of withheld tax by filing a return if that payee never provides a Form W-8 (or if the financial institution failed to provide the certificate). The payee's entitlement to the exemption depends on each financial institution in a chain providing the certificates as required, something the payee cannot directly control.

The basis for this approach is a 1986 technical correction, under which interest can qualify as portfolio interest if the withholding agent "receives" rather than "has received" the required form of certification. The legislative history indicates that this change is designed to permit a foreign payee to file Form W-8 with the withholding agent after receiving interest and thereby obtain a refund of taxes withheld by a withholding agent to whom a certificate had not previously been provided.

Under the final regulations, a withholding agent makes a payment without withholding, even though it cannot reliably associate the payment with the documentation prior to the payment, Reg. §1.1441-1(b)(7) applies. This regulation provides that a withholding agent can receive documentation at any time within its own limitations period to establish an applicable reduction in the withholding rate after the fact (e.g., under an income tax treaty). This cure procedure does not confer portfolio interest status to the interest if it occurs after the beneficial owner's statute of limitations has expired. If a certificate is provided after the withholding agent has made payment and fails to withhold, the district director or the Assistant Commissioner may require proof of payment of tax if it is determined that the delays in obtaining the obtaining the withholding certificate affect its reliability.[65] This certificate does not exonerate the withholding agent from interest and penalties for failure to withhold, even if the agent acted in good faith.[66]

Until 2000, the position of the withholding agent is less favorable. The Form W-8 or other certification must be received before payment is made and penalties and interest can be imposed even if the foreign payee pays the tax or proves directly to the IRS that the interest is exempt.

[¶5014.4] OBLIGATIONS IN BEARER FORM

In this portion of the analysis, we consider the requirements applicable to instruments not in registered form. The principal requirement is that it meet the foreign-targeting requirements of IRC §163(f)(2)(B). A secondary requirement is that the instrument must not be in registered form. This latter requirement has the effect that the instrument may comply with the registered form or the bearer form rules but it cannot comply with both.

>>>>GLOBAL NOTES>>>It might be thought that it would be simple to ensure that an obligation intended to comply with the bearer form rules is not in registered form. However, it is not sufficient for the instrument to state that it is transferable to bearer if in practice a system is

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64 Reg §1.871-14(e)(3)(i).

65 Reg. §1.1441-1(b)(7)(ii).

66 Reg. §1.1441-1(b)(7)(iii); See also IRC §1463.

in place under which a depositary has custody of the instruments and maintains what is in effect a book entry system. It is, in fact, not uncommon for Eurobonds governed by English law (or prepared by English lawyers), to be issued in the form of a single permanent global note, which is convertible to definitive notes. Pending conversion, the global note is held by one of the Eurobond clearing systems. If the issuer is a U.S. person and the portfolio interest exemption is therefore a requirement, the permanent global note must be convertible to bearer definitive notes at any time prior to maturity on demand by the holder.[67] Tax counsel should resist requests to make such a request unduly expensive or burdensome for the holder. In the absence of an unrestricted conversion option, the bonds may be held to be in registered form and subject to certification requirements, a situation Eurobond holders normally will not accept.

The foreign-targeting requirements represent an exception to the TEFRA sanctions against issuers of registration-required obligations that are not in registered form.[68] As explained below, efforts were made to coordinate these rules with practice in the markets and with the need to comply with the requirements of the U.S. securities laws.

Until 1990, any exemption from the requirement under the Securities Act of 1933 (the 1933 Act)[69] to register transnational issuances of securities with the Securities Exchange Commission (SEC) depended on SEC practice. SEC practice was reflected primarily in no-action letters, which approved procedures for issuance only to non-U.S. persons and lock-up periods during which the securities could not be resold in the United States or to U.S. persons. In June 1988, the SEC proposed rules to codify and simplify these procedures. After a lengthy comment period and consideration of the IRS position contained in proposed regulations issued in August 1989,[70] the SEC issued regulations in 1990, effective for offerings of securities on or after July 1, 1990. The IRS then issued its final regulations on May 8, 1990 and October 14, 1997, effective for obligations issued after September 8, 1990. The SEC and IRS position differed on certain key issues, most notably the definition of a "U.S. person" at whom the issue cannot be targeted and certification rules for SEC reporting corporations. Since the IRS position is less liberal, it may be assumed that issuers will be forced to follow IRS requirements.

(1) Bearer Form and Registered Form Contrasted

It is convenient to contrast instruments in both registered and bearer form. However, the statute does not refer to instruments in bearer form. It merely contrasts those instruments that are or are not in registered form, as defined in IRC §871(h)(6) and, ultimately, in the regulations under IRC §103, §149 and §163.

The regulations' definition of registered form require not only maintenance of a written record identifying the holder of the rights to principal and interest but also the exclusive use of one or both of two prescribed methods of transfer. It follows that an obligation may identify the holder but not be in registered form because of the method of transferring an interest in the obligation. We have already seen that this is the case with respect to traditional forms of promissory notes governed by the U.C.C.

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[67] See Ltr. Ruls. 9343018 and 9343019 (both dated July 29, 1993).

[68] See note and accompanying text.

[69] Securities Act of 1933, 15 U.S.C. §77b(7) [hereinafter cited as the 1933 Act].

[70] Prop. Reg. §1.163-5(c)(2)(i)(D) (Aug. 29, 1989).

Further, an instrument which is convertible to nonregistered form prior to maturity is treated from the moment of issuance as failing the registered form requirements. We will, for the sake of convenience, refer to obligations not in registered form as bearer obligations, but when used in connection with the portfolio interest exemption, the term should be understood in the broader sense.

(2) The Foreign-Targeting Requirements

The foreign-targeting requirements are defined in IRC §163(f)(2)(B) and greatly elaborated in the accompanying regulations.[71] The statute has three requirements:

! The targeting condition. Arrangements must exist reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to a person who is not a U.S. person.

! The interest payment condition. Interest must be payable only outside the United States and its possessions.[72]

! The legending condition. The obligation must be legended to state that any U.S. person who holds the obligation will be subject to limitations under the U.S. income tax laws.

The IRS has authority by regulation to exclude instruments of any type specified by regulation even though it otherwise meets the foreign-targeting requirements.[73] The Treasury has not, to date, exercised this authority.

The targeting condition. Four tests for satisfying the targeting condition are listed under Reg. §1.163-5(c)(2). Two of these, known in the market as TEFRA A and TEFRA B, apply only to obligations issued on or before September 8, 1990. TEFRA D applies to obligations issued after that date. TEFRA C, as explained below, does not involve the portfolio interest exemption.

TEFRA C Rules. The TEFRA C rules are and continue to be designed primarily to enable foreign branches of U.S. banks to carry on normal banking business abroad without having to put their obligations in registered form.[74] TEFRA C is of no particular relevance to the portfolio interest exemption, since interest on those obligations generally is exempt under

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[71] Reg. §1.163-5(c), TD 8110, 1987-1 CB 81.

[72] The term "possession" includes Puerto Rico, the U.S. Virgin Islands, Guam, American Samoa, Wake Island, and the Northern Mariana Islands. Reg. §1.163-5(c)(2)(iv).

[73] IRC §163(f)(2)(C).

[74] Reg. §1.163-5(c)(2)(i)(C) (part of the regulations describing the foreign-targeting rules that apply for purposes beyond the portfolio interest rules) in fact describes a broader category of instruments than stated in the text. For example, it covers certain instruments issued by foreign banks, including banks that are controlled foreign corporations. Interest on obligations issued by foreign corporations is not subject to the 30% withholding tax regardless of whether the portfolio interest exemption applies. (This rule in turn is subject to an exception when the interest is paid by a U.S. branch of a foreign corporation--see IRC §884(f)(1)(A)--in which case the obligation probably cannot meet the requirement that the issuer not engage in interstate commerce with respect to the issuance of the obligation. We accordingly do not further consider the exception.)

IRC §871(i) or 881(d).[75]

An obligation can meet the TEFRA C rules if it is issued directly to the public by the foreign branch of a U.S. bank outside the United States (and not as part of a larger issuance made by means of a public offering). The key requirement of the TEFRA C rules is the obligation that the bank not engage significantly in interstate commerce regarding the issuance of the obligation, either directly or indirectly.[76] In addition, an obligation cannot meet the TEFRA C rules if it is guaranteed by a U.S. shareholder of the issuer, is convertible into a debt or equity interest in that shareholder, or is substantially identical to an obligation issued by that shareholder.[77]

TEFRA D Rules.[78] The TEFRA D rules, set out in Reg. §1.163-5(c)(2), replace the TEFRA A and B rules for obligations issued after September 8, 1990. (TEFRA C remains in place.) TEFRA D requires the obligation to meet all the following four tests plus a selling restrictions notice:

! Offering and sale during restricted period. During a prescribed restricted period, neither the issuer nor the distributor may sell or offer to sell the obligation to a person who is within the United States or its possessions or is a U.S. person.[79] For this purpose, the distributor (but not the issuer) will satisfy the requirement if it covenants to do so and has reasonable

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[75] Before the Tax Reform Act of 1986, this interest was exempt because under IRC §861(a)(1)(A), it was somewhat artificially treated as having a foreign source. See Tax Reform Act of 1986, Sec. 1214(c), amending IRC §861(a)(1)(A), §871(i), and §881(d). As to other types of issuances covered by the TEFRA C rules, see note above.

[76] Reg. §1.163-5(c)(2)(iii) provides an extensive illustrated definition of the term "interstate commerce."

[77] Reg. §1.163-5(c)(2)(ii).

[78] The TEFRA A and B rules are briefly summarized in this note for reference purposes with respect to obligations issued on or before September 8, 1990. To meet the TEFRA A rules, the obligation could only be offered for sale or resale, and was required to be delivered, outside the United States. In addition, the issuer was required, in reliance on counsel's opinion received prior to issuance, determine in good faith that the obligation need not be registered under the 1933 Act because it was intended for distribution to non-U.S. persons. The term "U.S. person" for this purpose is used here in the same sense as for the purposes of the 1933 Act. Reg. §1.163-5(c)(2)(i)(A) last sentence.

Under the TEFRA B rules, the obligation could be registered under the 1933 Act, or could be exempt under §3 or 4 of the 1933 Act, or could be an obligation that did not qualify as a security under the 1933 Act. The TEFRA B rules imposed an elaborate set of further requirements designed primarily to ensure that the obligation is being marketed only to foreigners or to U.S. financial institutions for resale to foreigners. Many of these requirements were included in modified form in the TEFRA D rules.

[79] Reg. §1.163-5(c)(2)(D)(1). See text discussion accompanying note for rules relating to the restricted period.

procedures in place to ensure that its employees or agents are aware that the obligation can only be offered or sold on a restricted basis.

Two special rules apply. First, an offer or sale is treated as made within the United States or its possessions if the offeror or the seller has a U.S. address for the offeree or buyer regarding the offer or sale. Second, offers and sales may be made to exempt distributors,[80] international organizations,[81] a foreign central bank[82] or a foreign branch of a U.S. financial institution.[83] These sales are deemed to be made outside the United States and its possessions.

The term "distributor" is defined as (1) a person who offers or sells the obligation during the restricted period pursuant to a written contract with the issuer or with another distributor and (2) any affiliate of the issuer or a distributor that acquires the obligation with a view to offering or re-selling it during the restricted period.[84]

>>>>**SEC PARALLEL**>>>Regulation S under the 1933 Act requires that all participants must agree that all offers and sales during the restricted period will be made in accordance with Regulation S or pursuant to some other 1933 Act registration requirement (such as the exemption for private placements). In addition, offering materials and advertisements must include a statement that the securities have not been registered under the 1933 Act and may not be sold in the United States or to U.S. persons unless an exemption from registration is required. In this connection, the SEC's definition of U.S. person is more liberal than that of the IRS because it does not include U.S. citizens living abroad.

The restricted period begins on the earlier of the closing date (or the date when the issuer receives the proceeds, if there is no closing) or the first date when the obligation is offered for sale to a person other than a distributor. It ends 40 days after the closing (or receipt of loan proceeds absent a closing). However, an offer or sale is deemed to be made during the restricted period if the issuer or distributor holds the obligation as part of an unsold allotment or

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[80] See Reg. §1.163-5(c)(2)(i)(D)(5): An exempt distributor is a distributor that covenants with the issuer or another distributor that it is buying for the purposes of resale in connection with original issuance of the obligation and that if it retains the obligation for its own account, it will comply with certain conditions relating to transactions involving foreign branches of U.S. financial institutions. See Reg. §1.163-5(c)(2)(i)(D)(6) for further details.

[81] "International organizations" is defined by cross-reference to IRC §7701(a)(18) as a public international organization under the International Organizations Immunities Act, 22 U.S.C. §288-288f. A list of such organizations can be found in annotations to 22 U.S.C.A. §288 (1982; Supp. 1993).

[82] IRC §895 and regulations thereunder.

[83] See Reg. §1.163-5(c)(2)(i)(D)(6)(i).

[84] Reg. §1.163-5(c)(2)(i)(D)(4). Affiliate is defined by cross references to the definition of an affiliated group under IRC §1504(a) but with a 50% rather than 80% threshold and without regard to the exceptions in IRC §1504(b) so that a foreign corporation can be an affiliate.

subscription.[85]

! Delivery. In connection with the obligation's sale during the restricted period, the obligation may not be delivered in definitive form within the United States or its possessions.[86]

! Certification. On the date of the first payment of interest by the issuer or the date of issuance of the obligation in definitive form, the issuer must receive a certification stating that on that date the obligation is owned by one of the following:

(1) A person who is not a U.S. person.

(2) A foreign branch of a U.S. financial institution.

(3) A U.S. person who hold the obligation through the foreign branch of a U.S. financial institution.

(4) A U.S. financial institution certifying that it has not acquired the obligation for purposes of resale directly or indirectly to U.S. persons or persons within the United States or its possessions. A temporary global security is not treated as an obligation in definitive form.[87]

There is an exception to the certification rules for foreign currency securities issued in a country where the IRS has designated the foreign country as one which does not permit certifications under the foregoing rules and a variety of other conditions are satisfied.[88] The IRS has designated Germany and Switzerland.[89] Provision is made for electronic certification.[90]

! Regulation S Certification. Certification requirements under Regulation S depend on which of three defined categories of transactions created by the regulation applies to the offering. Category 1 applies to offerings by non-U.S. issuers which reasonably anticipate no substantial U.S. marketing interest. Category 2 covers all other offerings by non-U.S. issuers and offerings by U.S. issuers subject to the periodic reporting requirements of the Securities Exchange Act of 1934. Category 3 applies to all remaining issues.

Regulation S eliminates certification for Category 1 and 2 transactions. Category 1 transactions are effectively covered by TEFRA C and therefore are not subject to the certification requirements of either the IRS or the SEC. Category 2 transactions of U.S. issuers (and non-U.S. issuers engaged in a trade or business in the United States) are also covered by TEFRA D, however, and thus certification will continue to be needed.

As for Category 3 transactions, Regulation S prescribes a lock-up period for the securities which can be broken only by a certification that the securities have been acquired either by a non-U.S. person or by a U.S. person who acquired the securities in a transaction exempt from registration under the U.S. securities laws.

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85 Reg. §1.163-5(c)(7).

86 Reg. §1.163-5(c)(2)(i)(D)(2).

87 Reg. §1.163-5(c)(2)(i)(D)(3)(i) sets out the basic certification requirements. For the meaning of the expression temporary global security, see note below.

88 Reg. §1.163-5(c)(2)(i)(D)(3)(iii).

89 Notice 90-55, 1990-2 CB 344.

90 Reg. §1.163-5(c)(2)(i)(D)(3)(ii).

Selling restrictions notice. In addition to the TEFRA D requirements, Regulation S requires any participant in the distribution of a security to deliver a "selling restrictions notice" to any dealer during the restricted period. The notice advises that the purchaser is subject to the same restrictions on sales and offers and sales as a participant in the distribution.

>>>>**TRANSITIONAL RULE**>>>For issuances after May 10 and before September 7, 1990, a transitional rule permitted reliance on any of the TEFRA A, B, and C rules as well as the new TEFRA D rule.[91]

The interest payment condition. The interest payment condition requires that interest (but not, apparently, principal) be payable only outside the United States and its possessions. The regulations on this subject provide that interest will be considered payable outside the United States only if the following conditions are met:

! Payment may be made only on presentation (outside the United States or its possessions) of a coupon or other demand for payment to the issuer or a paying agent. The filing of a lawsuit within the United States following default does not constitute a demand for payment in this context.[92]

! Payment cannot be made by a transfer of funds into a U.S. account of the payee or by mail to a U.S. address, unless the payee either (1) is a person who can satisfy requirements under IRC §165(j)(3)(A), (B), or (C) (relating to persons holding obligations in connection with a non-U.S. trade or business, registered broker dealers holding obligations for sale to customers, and persons who comply with prescribed reporting requirements) or (2) is a financial institution and the payment is made as a step in the clearance of funds resulting in prompt crediting to a foreign account either of the financial institution or the customer for whom it is collecting the interest.[93]

Payment is not made in the United States merely because it is made by a draft drawn on a U.S. bank or is wired or electronically transferred from a U.S. account. Also, an exception is made if

(1) the interest may become payable at the office of the issuer or a U.S. paying agent if the issuer has appointed paying agents outside the United States with the reasonable expectation that these paying agents will be able to pay the interest in dollars and

(2) the making of full payment at the offices of all these paying agents becomes illegal or is effectively precluded by exchange controls or other similar restrictions on the payment or receipt of interest in U.S. dollars.

Actual place of payment. The actual place of payment is determined under Reg. §1.6049-5(e).[94] This regulation describes general principles and provides specific examples of

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[91] Reg. §1.163-5(c)(3).

[92] Reg. §1.163-5(c)(2)(v). The same provision also permits payment by an issuer or paying agent at a U.S. office if the issuer had previously appointed non-U.S. paying agents with the reasonable expectations that they would be able to pay in U.S. dollars and full payment in dollars has become illegal or effectively precluded because of the imposition of exchange controls or similar restrictions.

[93] Reg. §1.163-5(c)(2)(v).

[94] Reg. §1.6049-5(e).

its application.

Initially, Reg. §1.6049-5 defines the place of payment as the place where the payor or withholding agent (or "middleman", in the language of the regulation) completes the acts necessary to effect payment. The fact that payment is made by draft or wire transfer from a U.S. account of a U.S. or foreign bank is not determinative. The regulation also states that payment by wire or electronic transfer to a U.S. account of the payee will not be considered as made outside the United States for purposes of the interest payment condition.

Reg. §1.6049-5(e)(2) provides that, subject to the provisions concerning wire and electronic transfers, payment is considered to be made at the branch or office where it credits the interest.[95] This aspect of the regulation, by its terms, applies only to interest on deposits with the bank. But it would be reasonable to suppose that, for portfolio interest exemption purposes, it applies to any payment of interest.

Interest coupons. In the case of interest coupons, payment will be considered made in the United States if the coupons are presented to the issuer or withholding agent in the United States or if payment is credited to a U.S. account of the payee with the payor or withholding agent.[96]

>>>>**BETTER GUIDANCE NEEDED**>>>The regulations would be more helpful if they positively stated what will and will not be considered as payment outside the United States, or if they stated that a payment will be considered as made outside the United States unless one or more clearly specified conditions are met.

The legending condition. When a legend is required, the statement must be in English in substantially the following words:

Any United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in Sections 165(j) and 1287(a) of the Internal Revenue Code.[97]

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[95] The regulation provision requires that the branch meet certain conditions designed to establish that it is a real branch. These include the requirement that the branch be a permanent place of business in which a banking business is conducted by at least one employee regularly in attendance during normal business hours. This business must consist of the receipt of deposits plus at least one other banking activity. This requirement can affect the considerable number of U.S. banks with offshore branches maintained at and by banks in, for example, the Channel Islands, or the Bahamas. In the context of the portfolio interest exemption, it seems a little unreasonable to expect a customer of the bank to determine whether the branch in fact complies with the stated conditions.

[96] Reg. §1.163-5(c)(2)(v).

[97] Reg. §1.163-5(c)(1)(ii)(B). IRC §165(j) disallows losses, and IRC §1287 mandates ordinary income treatment for gains on a registration-required obligation unless that obligation is in registered form (or was subject to the excise tax under IRC §4701). This does not mean that gains or losses incurred by a U.S. holder of a bearer bond will automatically be subject to these sanctions. That occurs only if the bond should originally have been issued in registered form but was not. There is nothing that prevents a U.S. person from acquiring a bearer bond in the secondary market, provided that such person identify himself or herself as a U.S. person with an IRS Form W-9.

The legend is not required if the obligation is a temporary global security or satisfies the third test for the targeting condition.[98]

The legend must be placed on the bond as well as on any detachable interest coupon. If title to the obligation is evidenced by a book entry (for example, if the obligation is registered but does not meet all the requirements to be in registered form), the legend must appear instead in the book or record in which the book entry is made.[99]

[¶5014.5] WITHHOLDING AND INFORMATION REPORTING

The United States imposes two types of withholding on interest and two related reporting requirements: Withholding on interest paid to foreign persons and back-up withholding on "reportable payments". In general, Chapter 3 of the Code requires a withholding agent to withhold a tax of 30% on payments of interest to foreign persons, including nonresident aliens (which, for this purpose, include foreign estates and trusts), foreign corporations, and foreign partnerships.[100] The Code also imposes back-up withholding on reportable payments of interest to non-exempt persons (generally individuals and noncorporate entities).[101] Back-up withholding generally does not apply to payments to foreign persons but the two types of withholding intersect and overlap because both are concerned with ensuring that the payee's identity and/or classification (as a foreign person or as a corporate or noncorporate person) is known to the payor of the interest.

On October 14, 1997, the IRS issued a comprehensive revision of the withholding rules which become effective January 1, 2000.[102] These regulations resolve a number of troublesome issues for withholding agents, in particular by establishing uniform standards regarding the withholding agent's due diligence and duty to inquire.

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[98] Reg. §1.163-5(c)(1)(ii)(B) defines a temporary global security as "a security which is held for the benefit of the purchasers of the obligations of the issue and interests in which are exchangeable for securities in definitive registered or bearer form prior to its stated maturity." A temporary security is issued without interest coupons or conversion privileges and cannot be exchanged for definitive securities with coupons and conversion privileges (if applicable) until the end of the restricted period. A temporary global security is a single temporary security issued to the managing underwriter representing the right to all the definitive securities and is used to avoid the inconvenience of having to issue numerous (sometimes tens of thousands) temporary certificates which will be replaced once the restricted period ends. See also Rev. Rul. 89-9, 1989-1 CB 76 for a discussion of temporary global securities in the pre-TEFRA D context.

[99] This is a curious requirement because the legend does not then provide the appropriate notification to the holder of the obligation, which is presumably the point of the legend requirement.

[100]. IRC §1441(a), §1442(a); Reg. §1.1441-1, §1.1441-2(a).

[101] IRC §3406.

[102]. Reg. §1.1441-0 et. seq. (Oct. 14, 1997); the original January 1, 1999 effective date was extended to January 1, 2000 by Announcement 98-15, 1998-110 IRB 36.

The following summarizes the reporting and withholding requirements for obligations first in registered then bearer form. The next segment deals with a number of issues affecting withholding agents and concludes with a discussion of gross-up provisions.

(1) Registered Form Obligations

Withholding. Section 1441(c)(9) exempts portfolio interest from withholding. The provision of a Form W-8 is the method by which the withholding agent is advised that the payee is foreign and is therefore not subject to back-up withholding and is entitled to the portfolio interest exemption if the other requirements for interest on obligations in registered form are met.

Forms W-8, 1042 and 1042S. Even though portfolio interest is exempt from tax, the withholding agent generally is required to file Forms 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons) and 1042S (Foreign Person's U.S. Source Income Subject to Withholding) for all payments of portfolio interest on a registered obligation. Form 1042 is a summary of all payments made to foreign persons that are subject to (or exempt by treaty from) withholding and identifies the payees and the amounts withheld.[103] The form must be accompanied by copies of each 1042S issued by the withholding agent and each Form W-8 received by the withholding agent. Form 1042S is a form that must be given separately by the withholding agent to each payee.

The 1997 withholding regulations continue to require a Form 1042-S for payments of portfolio interest on an obligation in registered form.[104]

With foreign-targeted registered obligations, Form 1042S is only required if a Form W-8 or substitute form is provided.[105]

Form 1001. Form 1001 (Ownership, Exemption or Reduced Rate Certificate) is the form used to establish entitlement to a tax treaty exemption or rate reduction.[106] Under the final withholding regulations, Form 1001 will be replaced in 2000 by Form W-8, with Part II of the form dealing with treaty benefits.) The holder of a portfolio interest obligation is not required to file a Form 1001 with the withholding agent nor will the holder have to complete Part II of Form W-8, although they may do so if they want the additional treaty protection.

Forms 1096 and 1099-INT; back-up withholding. Provided the payor does not have actual knowledge that the payee is a U.S. person, neither information reporting on Forms 1096 (Annual Summary and Transmittal of U.S. Information Returns) and 1099-INT (Statement for Recipients of Interest Income) nor back-up withholding applies when a Form W-8 has been

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[103] Reg. §1.1441-1(b)(7)(ii) and Reg. §1.1461-2(b). Form 1042S is filed with Internal Revenue Service Center, Philadelphia, Pennsylvania 19255.

[104] Reg. §1.1461-1(c)(2) provides that income is subject to reporting on Form 1042-S if it is "subject to withholding" under Reg. §1.1441-2(a). Fixed or determinable annual or periodical income from a U.S. source is "subject to withholding" for reporting purposes even if the recipient is entitled to an exemption from tax or withholding. (This is not clear in the regulations but it is clearly stated in the Supplementary Information description of Reg. §1.1461-1(c)(2).) As noted below, a specific exclusion is provided for portfolio interests on bearer obligations.

[105] Reg. §1.871-14(e)(4)(i)(G).

[106] Reg. §1.1461-1(i).

provided or the foreign-targeting requirements have been complied with. This does not, however, exempt a person acting as the payee's custodian, nominee, or other agent from reporting obligations if that person is otherwise required to report under the information reporting rules of IRC §6049 relating to interest payments.[107]

Broker reporting. The extensive reporting requirements applicable to brokers under IRC §6045 are applicable to the retirement or redemption of a foreign-targeted registered obligation. However, those requirements do not apply if the broker receives a statement under Reg. §1.6045-1(g)(1) that the customer is an exempt foreign person (a foreign person who certifies, in effect, that he or she is not a U.S. resident citizen, or former citizen subject to IRC §877 (expatriation to avoid tax), or subject to U.S. tax on ECI).[108]

(2) Bearer Obligations

Withholding. The Section 1441(c)(9) exemption from withholding applies equally to obligations in bearer form that comply with TEFRA C or D.

Form 1042 and 1042S. The withholding agent is not required to file a Form 1042 or 1042S for payments of portfolio interest on bearer obligations.[109] This is not changed by the new regulations on withholding.

Forms 1096 and 1099-INT; back-up withholding. Provided the payor does not have actual knowledge that the payee is a U.S. person and payments are made outside the United States, information reporting on Forms 1096 and 1099-INT and back-up withholding generally do not apply to U.S.-source portfolio interest on foreign-targeted bearer obligations.[110] This does not, however, exempt a person acting as the payee's custodian, nominee, or other agent from reporting obligations if that person is otherwise required to report under the information

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[107] The regulations cite the example of a foreign branch of a U.S. bank collecting interest on behalf of a customer unless either the customer is an exempt recipient or the branch has the requisite documentary evidence that the customer is not a U.S. citizen or resident. Virtually all entities (other than partnerships) are exempt recipients. The list in Reg. §1.6049-4(c)(1)(ii) lists: (1) a corporation; (2) a pension plan or an IRA; (3) the United States, the states, and the District of Columbia, a U.S. possession, and their political subdivisions and wholly-owned agencies; (4) a foreign government or political subdivision thereof, or an international organization; (5) a foreign central bank; (6) a registered dealer in securities or commodities; (7) a REIT; (8) a regulated investment company; (9) a common trust fund; (10) a nominee or custodian; (11) a thrift or other similar financial institution; (12) a broker; and (13) various types of charitable trusts.

[108] Reg. §1.1441-1(b)(5)(v).

[109] Reg. §1.1441-2(a) and Reg. §1.1461-1(b)(1).

[110] Reg. §1.6049-5(b)(7). Similar rules apply to foreign source interest paid by U.S. persons or CFCs, interest paid in various circumstances by resident aliens and foreign corporations meeting the 80% foreign business requirements of IRC §861(c), and OID on obligations with a maturity of six months or less. See Reg. §1.6049-5(b). Because these provisions apply to interest that is exempt from tax under provisions of the Code other than the portfolio interest exemption under IRC §871(h) and 881(c), this analysis does not consider them further.

reporting rules of IRC §6049.[111]

Broker reporting. The reporting requirements applicable to brokers under IRC §6045 are not applicable to the retirement or redemption of a foreign-targeted bearer obligation, provided the issuer or agent has no knowledge that the payee is a U.S. person, the obligation is presented for retirement or redemption outside the United States, and payment is not made in the United States.[112]

(3) Withholding Agent Issues

A full description of the general duties and responsibilities of a withholding agent are beyond the scope of this analysis. Among other things, no consideration is given to the rules under the new final regulations applicable to qualified intermediaries and authorized foreign agents. The following are some comments specifically relevant to the role of the withholding agent when the portfolio interest exemption is claimed.

In the case of portfolio interest, the new regulations confirm the statutory rule that withholding is not required on interest meeting the requirements of the exemption.[113] The withholding agent's first task is therefore to determine whether a payment does in fact constitute interest.[114] Once that determination is made, the withholding agent must determine whether the interest is of a type subject to withholding.[115]

Existing regulations give no guidance at all on how a withholding agent is to determine whether a payment is interest and the final regulations are equally silent on this point. Existing regulations also did not state what reliance a withholding agent could place on a claim that interest is portfolio interest. The final regulations now allow the withholding agent to accept a claim that it is portfolio interest unless it knows or has reason to know otherwise. (When a recipient of interest claims to be exempt or entitled to a reduced treaty rate, the withholding agent may rely on a Form 1001 a statement under penalty of perjury that the recipient is entitled to the benefit of the treaty). The IRS has ruled that the withholding agent can rely on such a statement unless he or she has reason to know it is inaccurate.[116] This rule is codified in the new regulations.[117])

In the case of a registered obligation, the withholding agent has to determine the

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[111] Reg. §1.6049-4(c)(1)(i)-(ii).

[112] Reg. §1.6045-1(g)(1)(ii).

[113]. Reg. §1.1441-1(b)(4)(i) (bearer form obligations).

[114]. See Part One of this analysis at ¶ 5014.2(3).

[115]. The withholding requirement does not precisely correspond with liability for the tax. There are situations when withholding is not required although tax is due and vice-versa. See Dale, “Withholding Tax on Payments to Foreign Persons”, 36 Tax Law Review 49, 67 (1980) (hereinafter, Dale, Withholding Tax).

[116]. Rev. Rul. 76-224, 1976-1 CB 268, rules that this is implicit in Reg. §1.1441-6, requiring the recipient to furnish a Form 1001 to claim a treaty benefit. See Dale, Withholding Tax, at 82.

[117]. Reg. §1.1441-6(b)(1), which cross-refers to Reg. §1.1441-1(e)(1).

following matters:

! *Is the obligation in registered form?* If the withholding agent is the issuer or the issuer's registrar, this issue is less troublesome than in other cases. Nonetheless, the withholding agent must examine the obligation and make a determination concerning this issue. There is no safe harbor method on which a withholding agent can conclusively rely absent knowledge of impropriety.

! *Has the statement required by IRC §871(h)(5) been provided?* This requires either a Form W-8 or one of a chain of financial institution certifications accompanied by a copy of the Form W-8, as described in greater detail in ¶5014.3.

! *Is there any exception that would otherwise deny the benefits of the portfolio exemption?* The most prominent exceptions are those relating to obligations involving 10-percent shareholders, foreign banks, and CFCs of related persons. IRC §1441(c)(9) and §1442(a) provide that, in the case of portfolio interest, no tax is required to be deducted and withheld unless the withholding agent knows or has reason to know that the interest is disqualified because of the 10-percent shareholder, CFC, or foreign bank rules.

In the case of interest on registered-form obligations, the final regulations provide that a withholding certificate's duty to inquire as to a Form W-8 or other form of beneficial owner withholding certificate is limited to situations when (i) the permanent residence address on the form is in the United States; (ii) the payment address is directed to a P.O. Box, an in-care-of address, a U.S. address or a financial institution in the United States; or (iii) the beneficial owner notifies the withholding agent of a mailing address that differs from the permanent residence or mailing address on the form and the mailing address is described in (i) or (ii). If a treaty benefit is also claimed, the withholding agent has a duty to inquire if the permanent residence or mailing address is not in the treaty country.[118]

In the case of a bearer obligation, the withholding agent's difficulties are more substantial. Throughout the term of the obligation, entitlement to the exemption depends on foreign-targeting rules having been complied with at the time of issuance. It is well established that reliance on an erroneous counsel's opinion will not protect the withholding agent against the obligation to pay underwithheld tax and interest, although it may protect against penalties.[119]

The withholding agent must, in any event, be familiar with the rules concerning payment outside the United States. These rules are not models of clarity and, although the IRS has said in the past that it intends to amplify them with examples, this guidance is evidently a very low priority and there is no active regulations project on this point.

Finally, additional uncertainty arises for withholding agents in the face of the regulations under IRC §7701(l). A withholding agent is required to withhold as if the IRS District Director had determined that all conduit entities that are parties to a conduit financing arrangement should be disregarded. This rule applies even if the withholding agent is unrelated to both the financing entity and the financed entity.[120] This new requirement does not apply if the withholding agent

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118. Reg. §1.1441-7(b)(2)(ii).

119. Dale, Withholding Tax, at 79. See also, Comiskey, Feld & Harris, *Tax Fraud and Evasion* (Warren, Gorham & Lamont 1994, looseleaf) at ¶8.02[3][i].

120. Reg. §1.1441-3(g).

neither knew nor had reason to know that the financing arrangement is a conduit financing arrangement. The withholding agent must know of more than just the financing transactions--it must also know or have reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement including facts sufficient to establish that the participation of the intermediate entity was pursuant to a tax avoidance plan. Some examples are given, which should be required reading for withholding agents.[121]

Gross-up provisions. In many international finance transactions, the lender is unwilling to have any tax withheld. This is not just a matter of lender greed or tax evasion. As a practical matter, even a withholding tax rate as low as 5% on the gross amount of interest may be equivalent to a very high effective tax rate (as much as 100% or more) on the economic profit derived from borrowing or taking deposits.

> **Example.** Swissco, a Swiss resident, lends funds to Domco, a domestic corporation, at 10%. Swissco's cost of funds is 9.5%. On each $1,000 lent to Domco, it receives $100 in interest and earns a profit of 0.5% or $5 per $1,000 of principal. Under the Swiss treaty, the interest is taxable at 5%, or $5 per $100 of interest. The effective tax rate is therefore 100%. If 50 basis points seems like a modest profit margin, consider a lender subject to the full 30% tax rate who would require a 300 basis points spread to break even.

On the other hand, the first obligation of the borrower and any other withholding agent is to comply with the law, especially since it is usually that of their home country. The typical international financing agreement resolves this issue by requiring the borrower to pay additional amounts, which are treated as additional interest, so that, after deduction of any withholding tax, the lender receives a net amount equal to the originally specified amount of interest.

Generally, gross-up provisions in loan agreements or trust indentures involving U.S. borrowers are intended to allocate risk of withholding to the borrower but are not expected to operate unless there is a change in law or facts outside the parties' control. The borrower is usually permitted to repay the loan without penalty if a withholding tax is in fact imposed.

> >>>>**PRACTICAL POINT**>>>Gross-up provisions in Eurobond offerings in practice are subject to various exceptions. These usually include: (i) the effect of any connection between the bondholder and the country of the issuer (the United States for our purposes) other than the holding of the bond; (ii) failure of the bondholder to comply with certification, information, or reporting requirements; (iii) the effect of failure to present any bond in certificated form or any payment coupon for payment within a specified period after it falls due; and (iv) taxes not collected by withholding.

One potential point of contention between a borrower and any lender entitled to grossed-up payments is the fact that the lender may be entitled to the foreign equivalent of the foreign tax credit on the amount withheld. In effect, the lender may receive the full net amount of interest and, by virtue of the credit, may avoid its home country taxes based on the gross-up payment. In typical Eurobonds, the bondholder is never required to return this unintended benefit back to the issuer, even if it actually obtains a reduction in its home country tax burden. Potential reductions due to foreign tax credit carryovers, which may or may not be used in the future, generally are not made subject to return.

In private transactions, this issue will be resolved based on the relative bargaining power

[121]. Reg. §1.1441-7(d).

of the parties and, it must be said, the sophistication of the parties' advisors.

Back-up withholding. With back-up withholding, the situation is reasonably clear in the case of registered obligations--none is required if a Form W-8 or financial institution certification with a copy Form W-8 (foreign holder) or W-9 (U.S. holder) is provided to the withholding agent. The withholding agent should be entitled to rely on these certifications. In the case of bearer obligations, the withholding agent is once again required to determine that the foreign-targeting requirements have been complied with to determine that back-up withholding does not apply.

CONSULT TABLE UNDER THE TAB CARD "CROSS REFERENCE TABLE/INDEX" FOR OTHER ARTICLES AND NEW DEVELOPMENTS RELATED TO THIS SUBJECT

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