Repeal of the United States Withholding Tax on Interest Paid to Foreigners

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I. INTRODUCTION ............................................. 193
II. RULES GOVERNING THE ISSUANCE OF DEBT TO FOREIGN PERSONS PRIOR TO THE 1984 ACT ............................................ 194
   A. The Withholding Tax on Interest Paid to Foreign Persons and Exemptions ........................................ 194
   B. Issuance of Debt in the Eurobond Market by Finance Subsidiaries of U.S. Corporations ............................... 197
      1. Effect of the Withholding Tax on the Structure of Eurobond Debt ........................................ 197
      2. The Use of Foreign Finance Subsidiaries ............. 197
      3. Tax Issues Relating to Foreign Finance Subsidiaries ... 199
   C. Compliance Requirements of U.S. Tax Law With Respect to the Issuance of Debt to Foreign Persons .................. 201
      1. Information Reporting and Backup Withholding .......... 201
      2. Issuance of Debt “In Registered Form” .................. 203
   D. Applicability of U.S. Estate Tax to Eurobond Debt Held by Foreign Persons ............................................. 205
III. THE 1984 ACT AND THE TEMPORARY REGULATIONS RELATING TO PAYMENT OF U.S. SOURCE INTEREST AND PRINCIPAL TO FOREIGN PERSONS ............................................. 205
   A. Repeal of U.S. Withholding Tax on “Portfolio Interest” Paid to Foreign Persons ........................................ 205
      1. Definition of “Portfolio Interest” ..................... 206
      2. Exceptions to “Portfolio Interest” ..................... 207
         a. Interest Received by a Ten Percent Shareholder ...... 207
         b. Interest Received by Foreign Banks .................. 207
         c. Interest Received by a Controlled Foreign Corporation from a Related Person .................. 208
         d. Inadequate Exchange of Information .................. 208
         e. Registration-Required Obligations .................. 209
      3. Bearer Debt Obligations .................................. 216
         a. U.S. Government Obligations in Bearer Form ........ 216
b. Safe Harbor for Certain Bearer Debt Obligations... 221
  c. Satisfaction of the Eurobond Registration Exemption 223
4. Registered Debt Obligations ........................ 231
  a. Non-Targeted Registered Obligations .............. 232
  b. Targeted Registered Obligations .................. 236

B. Exemptions from Information Reporting and Backup Withholding ........................................... 241
1. Payments of Portfolio Interest on Bearer and Registered Obligations .......................... 241
2. Interest on Deposits With U.S. Financial Institutions ......................................................... 243
  a. Deposits of One Year or Less .................... 244
  b. Deposits of More Than One Year ................. 244
3. Short-Term Discount Obligations .................... 245
4. Payments of Principal ................................ 245

C. Estate Tax Exemption ................................ 246

IV. Effects of the Withholding Tax Repeal on International Capital Markets .......................... 246
Repeal of the United States Withholding Tax on Interest Paid to Foreigners

by

Peter E. Pront†

and Roger M. Zaitzeff*

I. INTRODUCTION

The Tax Reform Act of 1984¹ (hereinafter the 1984 Act) included a significant provision enhancing U.S. Government and private business access to international capital markets. This provision, contained in section 127 of the 1984 Act, generally repealed the 30 percent U.S. withholding tax on interest received by nonresident aliens and foreign corporations, partnerships, trusts and estates (hereinafter Foreign Persons) from certain debt obligations issued after July 18, 1984 by U.S. corporations, the U.S. Government and certain foreign corporations engaged in a substantial amount of business activity in the United States. Congress intended this repeal to increase the ability of U.S. borrowers, including the Treasury, to raise funds in foreign capital markets and to eliminate the need for these borrowers to use intermediary financing affiliates.²

Following passage of the 1984 Act, securities firms and financial institutions sought immediate guidance regarding the specific rules governing this general repeal of the U.S. withholding tax on interest. The Treasury Department responded with temporary regulations addressing various aspects of this repeal (hereinafter the Temporary Regulations).³ Certain important provisions of these regulations contain ambiguities and inconsistencies in light of

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3. 49 Fed. Reg. 33,228 (1984). The Temporary Treasury Regulations [hereinafter cited as Temporary Regulations] are structured in a question and answer format. In addition to providing guidance regarding the specific rules relating to the repeal of the U.S. withholding tax, these
the express terms of section 127, its legislative history and the underlying Congressional intent. These ambiguities and inconsistencies have caused understandable concern in financial circles. Indeed, numerous representatives of the securities and investment banking community have expressed this concern through written comments sent to the Treasury Department and testimony given at a January 28, 1985 Treasury Department hearing. In response to certain of these comments and this testimony, the Treasury Department issued in August 1985 new Temporary Regulations amending aspects of the Temporary Regulations issued in 1984.4

This Article outlines the new rules relating to the repeal of the U.S. withholding tax on interest, analyzes the significant issues arising from this repeal, and discusses the probable effect of this repeal on international capital markets. Part II of the Article summarizes the pre-1984 federal income tax rules applicable to the issuance of debt obligations to Foreign Persons.5 Part III discusses the new provisions added to the Internal Revenue Code of 1954 (hereinafter the Code) by section 127 of the 1984 Act, the Temporary Regulations, and certain related announcements by the Treasury Department.6 Finally, Part IV discusses the immediate impact that the repeal of the withholding tax has had on the issuance of debt obligations in international capital markets and certain future effects which may result from this repeal.7

II. RULES GOVERNING THE ISSUANCE OF DEBT TO FOREIGN PERSONS PRIOR TO THE 1984 ACT

A. The Withholding Tax on Interest Paid to Foreign Persons and Exemptions

Prior to the 1984 Act, a Foreign Person receiving interest from most U.S. corporations, the U.S. Government (including an agency thereof or any enterprise sponsored by the U.S. Government) or certain foreign corporations regulations address the applicability of information reporting and backup withholding to payments made by persons or entities after July 18, 1984 of interest and principal to Foreign Persons. Information reporting refers to the Internal Revenue Code's requirement that payors of interest file annual reports with the Internal Revenue Service which contain the name of the persons to whom interest is paid, their taxpayer identification numbers and certain other information. See I.R.C. § 6049 (1984), infra notes 41-56 and accompanying text. Backup withholding refers to another aspect of the compliance provisions of the tax law which requires payors of interest and principal, in general, to withhold 20 percent of the interest or principal payments made to certain persons when circumstances indicate that the payor may not properly report all of the income it derives from certain investments. See I.R.C. § 3406, infra notes 41-56 and accompanying text. [All references to I.R.C. in this Article, unless otherwise indicated, are to sections of the Internal Revenue Code of 1954, as amended].

4. 50 Fed. Reg. 33,522 (to be codified at 26 C.F.R. pts. 1, 35a) (1985). Unless otherwise specified, the two sets of Temporary Regulations issued by the Treasury Department in August 1984 and August 1985 are collectively referred to herein as the Temporary Regulations.
5. See infra notes 8-66 and accompanying text.
6. See infra notes 67-275 and accompanying text.
7. See infra notes 276-284 and accompanying text.
engaged in substantial business activities in the United States (hereinafter U.S. Source Interest) generally was subject to federal income tax in one of two ways. First, U.S. Source Interest considered to be “effectively connected” with the conduct by such Foreign Person of a trade or business within the United States (hereinafter Effectively Connected Income) was taxed (net of certain deductions allocable to this income) to the Foreign Person generally at the graduated rates generally applicable to U.S. taxpayers. Second, the gross amount of U.S. Source Interest that did not constitute Effectively Connected Income to the Foreign Person generally was subject to a flat 30 percent tax. This flat tax was generally collected by withholding the amount of the tax from the interest payable to the Foreign Person. In most cases, the amount withheld by the U.S. payor represented the final U.S. federal income tax liability of the Foreign Person, and the Foreign Person was not required to file any Federal income tax return with respect to this income.

This withholding tax on U.S. Source Interest applied subject to both specific statutory exemptions and the rules contained in bilateral income tax treaties between the United States and certain foreign countries (hereinafter the Tax Treaties). For example, the Code specifically exempts from U.S. withholding tax certain types of interest paid to Foreign Persons by U.S. persons or entities. These exemptions include:

1. interest from deposits with banks, savings and loan associations and similar financial institutions carrying on a banking business;

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8. Sections 861 through 863 of the Code and the Treasury Regulations thereunder set forth specific rules for determining whether a particular item of income is treated as derived from sources within or outside of the United States. Under I.R.C. § 861(a)(1), income from sources within the United States generally includes interest from obligations issued by the United States and by corporations or individuals resident in the U.S. But see infra note 17 and accompanying text. Interest paid by a foreign corporation is also considered to be U.S. Source Interest if at least 50 percent of the aggregate worldwide gross income of the foreign corporation for the three preceding years (or such shorter period as the corporation was in existence) constituted income “effectively connected” to the U.S. business of the corporation. See I.R.C. § 861(a)(1)(C).

9. I.R.C. §§ 871(b), 882(a). Section 864(c) of the Code and the Treasury Regulations thereunder set forth specific rules for determining whether a particular item of income constitutes Effectively Connected Income.


14. Sections 861(a)(1)(A) and 861(c) of the Code treat such interest as income from sources outside of the United States, rather than as U.S. Source Interest. In determining whether a particular payment of interest qualifies for this statutory withholding tax exemption, the two key issues concern whether (1) the underlying debt obligation constitutes a “deposit”, and (2) the payor is “carrying on the banking business.” Time certificates of deposit, open account time deposits, and multiple maturity time deposits have all been held by the Internal Revenue Service to constitute “deposits” within the meaning of Code section 861(c). See Rev. Rul. 72-104, 1972-1 C.B. 209. See also Rev. Rul. 70-436, 1970-2 C.B. 148; Rev. Rul. 73-505, 1973-2 C.B. 224; Rev. Rul. 75-449, 1975-2 C.B. 285 with respect to the definition of a “deposit”. To be considered as
(2) "original issue discount"\textsuperscript{15} accruing on debt obligations with original maturities of 183 days or less (e.g., commercial paper and six-month United States Treasury Bills),\textsuperscript{16} and
(3) interest paid by a U.S. corporation which derived less than 20 percent of its aggregate worldwide gross income during a specified period from sources within the United States (hereinafter an 80/20 Corporation).\textsuperscript{17}

In addition to these statutory exemptions, Tax Treaties generally provide either an exemption from, or a reduced rate for, the withholding tax on U.S. Source Interest paid to Foreign Persons.\textsuperscript{18} These exemptions or rate reductions generally apply only if the interest paid is not "effectively connected" with a trade or business conducted by the Foreign Person within the United States through a "permanent establishment" or fixed base located in the United States.\textsuperscript{19} For example, the Tax Treaty between the United States and

\textsuperscript{15} "carrying on the banking business" an entity generally must have a license to engage in the banking business and hold itself out to the public as so engaged. See Rosenblum v. Anglim, 135 F.2d 512 (9th Cir. 1943); Estate of Rodolfo Ogarrio, 40 T.C. 2421 (1963), aff'd per curiam 337 F.2d 108 (D.C. Cir. 1964); Rev. Rul. 65-245, 1965-2 C.B. 379. Alternatively, a deposit must create a debtor-creditor relationship between the taxpayer and the entity receiving the deposit. See, e.g., Rev. Rul. 54-624, 1954-2 C.B. 16.

\textsuperscript{16} Subject to certain specific exceptions, the term "original issue discount" generally means the difference between the issue price of a debt obligation and the stated amount payable to the holder of the obligation at maturity (including any deferred interest payable at maturity). See I.R.C. § 1273, as added to the Code by § 41(a) of the 1984 Act. The statutory definition of "original issue discount" was contained in § 1232(b) of the Code until its repeal by the 1984 Act. See 1984 Act, supra note 1, § 42(a)(1). Except as specifically noted herein, all references in this article to "interest" include "original issue discount".

\textsuperscript{17} Section 861(a)(1)(B) of the Code excludes such interest from the definition of U.S. Source Interest. The three-year period referred to in § 861(a)(1)(B) is the three-year period (or such shorter period as the corporation has been in existence) ending with the close of the corporation's taxable year in which the interest is paid.

The Tax Reform Bill of 1985, as passed by the House of Representatives in December 1985, would amend the Code to continue to exclude interest paid by an 80/20 Corporation from the definition of U.S. Source Interest only to the extent that the corporation's income is derived from foreign sources in the active conduct of a trade or business (either directly or indirectly through subsidiaries) outside of the United States. With certain specific exceptions, this change in the treatment of interest paid by an 80/20 Corporation is proposed to apply to interest paid or accrued on or after January 1, 1986. H.R. 3838, 99th Cong., 1st Sess., § 612, 131 CONG. REC. H12625-26 (daily ed. Dec. 17, 1985).

\textsuperscript{18} An exemption from the 30 percent withholding tax on U.S. Source Interest generally is provided under the Tax Treaties between the United States and Austria, Denmark, the Federal Republic of Germany, Finland, France, Greece, Hungary, Iceland, Ireland, Italy, Luxembourg, the Netherlands, the Netherlands Antilles, Norway, Poland, Sweden, the USSR, and the United Kingdom. Reductions in the rate of U.S. withholding tax imposed on U.S. Source Interest generally are provided under Tax Treaties between the United States and Australia, Belgium, Canada, Egypt, Jamaica, Japan, Korea, Malta, Morocco, New Zealand, the Philippines, Romania, and Switzerland. See generally, 1 TAx TREATIES 21-163 (CCH) (1985).

\textsuperscript{19} For purposes of most Tax Treaties, income will be treated as "effectively connected" to a permanent establishment only if it constitutes Effectively Connected Income under the Code. See, e.g., Convention with Respect to Taxes on Income and Certain Other Taxes, Apr. 29, 1948, United States - Netherlands, art. VIII, para. 2, 62 Stat. 1757, T.I.A.S. No. 1855, at 7.
the Netherlands, as extended to the Netherlands Antilles (hereinafter the Netherlands Antilles Tax Treaty), generally exempts U.S. Source Interest paid to Netherlands Antilles Persons from U.S. withholding tax.\textsuperscript{20}

\textbf{B. Issuance of Debt in the Eurobond Market by Finance Subsidiaries of U.S. Corporations}

\textit{1. Effect of the Withholding Tax on the Structure of Eurobond Debt}

The Eurobond market constitutes the major capital market outside of the United States.\textsuperscript{21} This market consists of a network of underwriters and financial institutions that market debt obligations issued by private corporations, foreign governments, government agencies, and other borrowers. A secondary market for Eurobonds also exists.\textsuperscript{22} Purchasers of bonds sold in the Eurobond market include individuals, financial institutions, investment companies, insurance companies and pension funds. Eurobonds are generally issued in bearer form\textsuperscript{23} so that purchasers wishing to preserve their anonymity need not disclose their identity to the issuer or any governmental authority.

Issuers of debt obligations sold in the Eurobond market generally structure these obligations so that holders remain effectively insulated from the imposition of any withholding taxes. The issuer usually promises to pay interest, premiums, and principal on its obligations net of any withholding tax which may be imposed thereon for any reason. In addition, the issuer often retains the right to immediately redeem the obligations upon the imposition of a withholding tax resulting from either a change in law or a new interpretation of the law. This approach results in higher borrowing costs for the issuer, since payments to the holders of its debt obligations must be "grossed up" to cover any withholding taxes imposed thereon. Given the relatively small interest rate differential which generally exists between the U.S. debt market and the Eurobond market,\textsuperscript{24} the additional costs to a U.S. issuer involved in paying any withholding taxes on behalf of the holders would generally make borrowing in the Eurobond market economically unfeasible.

\textit{2. The Use of Foreign Finance Subsidiaries}

Prior to the enactment of the 1984 Act, U.S. corporations desiring to borrow money in the Eurobond market had to devise ways to avoid the U.S.

\textsuperscript{20} \textit{Id.}

\textsuperscript{21} \textit{See generally A. GEORGE \& I. GIDDY, INTERNATIONAL FINANCE HANDBOOK, § 5.1 (1983).}

\textsuperscript{22} \textit{Id.}

\textsuperscript{23} \textit{Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 394–95 (Jt. Comm. Print 1984) [hereinafter cited as General Explanation of the 1984 Act]. A bond in bearer form means the interest and principal on the obligation are payable to the person who is in physical possession of the written debt instrument evidencing the obligation.}

\textsuperscript{24} \textit{A. GEORGE \& I. GIDDY, supra note 21, at § 5.18.}
withholding tax when paying interest to Foreign Persons. One way to achieve this objective involved the issue of debt obligations overseas, either through wholly-owned U.S. finance subsidiaries constituting 80/20 Corporations, or through foreign finance subsidiaries incorporated in countries which were parties to favorable Tax Treaties. Due to the favorable provisions of the Netherlands Antilles Tax Treaty and the Netherlands Antilles tax law, U.S. corporations incorporated almost all of their foreign finance subsidiaries in the Netherlands Antilles.

Typically, a U.S. corporation would incorporate a finance subsidiary in the Netherlands Antilles (hereinafter an Antilles Finance Subsidiary) and contribute capital in an amount equal to one-third to one-fifth of the face amount of the Eurobond debt obligations to be issued by the Antilles Finance Subsidiary. The Antilles Finance Subsidiary would loan all of the net proceeds of its Eurobonds (and sometimes all or part of its equity capital) to its U.S. parent and/or to domestic and/or foreign affiliates of its U.S. parent. The terms and conditions of this loan would substantially match the terms and conditions of the Eurobonds, except that the Antilles Finance Subsidiary would charge its affiliates an interest rate approximately one percentage point higher than that paid on the Eurobonds. The Antilles Finance Subsidiary would issue its Eurobonds in bearer form, and the subsidiary's U.S. parent or affiliate would usually guarantee unconditionally the payment of principal and interest on the Eurobonds. Furthermore, the Eurobonds generally provided that the bondholders would receive the stated interest and principal payments on the bonds net of any U.S. or foreign withholding tax. Finally, the Eurobonds stipulated that the Antilles Finance Subsidiary could redeem the obligations upon the actual or likely imposition of a withholding tax on these payments.

U.S. corporations expected such a Eurobond debt issuance by an Antilles Finance Subsidiary to have the following tax consequences:

1. interest paid by a U.S. parent or affiliate to the Antilles Finance Subsidiary was exempt from U.S. withholding tax;
2. interest paid by the Antilles Finance Subsidiary to the Foreign Persons holding the Eurobonds was not subject to any Netherlands Antilles or U.S. withholding tax.

25. See supra note 17 and accompanying text. An 80/20 Corporation was often utilized where substantially all of the bond proceeds were to be used by foreign affiliates of the parent corporation. The foreign source interest received by the 80/20 Corporation from its loans of the bond proceeds to such foreign affiliates would enable the 80/20 Corporation, in turn, to pay interest to Foreign Persons which would be foreign source income and therefore exempt from U.S. withholding tax. I.R.C. § 861(a)(1)(B).


27. For a general description of a typical Eurobond financing through an Antilles Finance Subsidiary, see GENERAL EXPLANATION OF THE 1984 ACT, supra note 23, at 388-389; A. GEORGE & I. GIDDY, supra note 21, at § 5.1.

28. Netherlands Antilles Tax Treaty, supra note 19, at art. VIII.

29. The internal tax law of the Netherlands Antilles does not provide for any withholding tax on interest paid by a Netherlands Antilles corporation to a nonresident of the Netherlands.
(3) the Foreign Persons holding the Eurobonds were not subject to any U.S. or Netherlands Antilles estate, gift or inheritance tax with respect to the Eurobonds;\(^{30}\)

(4) pursuant to a ruling obtained from the Netherlands Antilles tax authorities, the Antilles Finance Subsidiary was subject to a 24 to 30 percent Netherlands Antilles income tax on its net interest income\(^{31}\) (i.e., the difference between the interest income received by the Antilles Finance Subsidiary from its affiliates and the interest paid by the Antilles Finance Subsidiary on the Eurobonds, which typically was equal to approximately one percentage point of the face amount of the Eurobonds); and

(5) the net income of the Antilles Finance Subsidiary was currently taxable to its U.S. parent for U.S. federal income tax purposes,\(^{32}\) but this income generally was offset by the interest deduction claimed by the parent for any interest it paid to the Antilles Finance Subsidiary. Further, the Netherlands Antilles income tax paid by the Antilles Finance Subsidiary on its net income could be claimed as a foreign tax credit by the U.S. parent.\(^{33}\)

The Antilles Finance Subsidiaries therefore provided significant benefits to those U.S. corporations seeking to eliminate withholding taxes on their Eurobond issues.

3. Tax Issues of Foreign Finance Subsidiaries

Prior to 1974, the Internal Revenue Service (hereinafter the IRS) published rulings which recognized, for certain federal income tax purposes, that debt obligations issued by an intermediary domestic or foreign finance subsidiary similar to the Antilles Finance Subsidiary described above constituted indebtedness of that finance subsidiary, if certain conditions were met.\(^{34}\) Beginning in 1974, however, the IRS refused to issue further rulings on issuance

Antilles. See Granwell, Repeal of the 30 Percent Withholding Tax on Interest Paid to Foreigners, 13 TAX MGMT. INT'L J. 307 (Sept. 1984). Article XII of the Netherlands Antilles Tax Treaty exempts from U.S. withholding tax interest paid by a Netherlands Antilles corporation to Foreign Persons. Netherlands Antilles Tax Treaty, supra note 19, at art. XII. See also I.R.C. § 861(a)(1)(C) (1982) (providing that interest paid by a foreign corporation is treated as foreign source income where less than 50 percent of the aggregate worldwide gross income of the foreign corporation over a specified three-year period constitutes Effectively Connected Income to the corporation).


31. See 1963 Protocol to the Netherlands Antilles Tax Treaty, art. I, para. 1. Absent a ruling from the Netherlands Antilles tax authorities, an Antilles Finance Subsidiary is not entitled to a deduction for interest paid to an entity other than a bank or a similar financial institution (e.g., insurance companies pension funds). See 1940 Profits Tax Ordinance of the Netherlands Antilles, art. 14, § 11b.

32. This net income was taxable to the parent as Subpart F income under § 954 of the Code.

33. See I.R.C. § 902. Section 127 of the 1984 Act and its addition of § 904(g) to the Code changes this result. This new statutory provision treats the Subpart F income taxed to the parent corporation as U.S. source income. I.R.C § 904(g).


Revenue Ruling 69-377 held that interest paid on debt obligations issued by a U.S. finance subsidiary with a 5 to 1 debt to equity ratio to persons other than corporations affiliated with the
of debt obligations by finance subsidiaries of U.S. corporations and revoked its prior rulings on this issue.\textsuperscript{35}

In addition, Eurobond issues by finance subsidiaries were subject to the tax risk that the IRS could treat the U.S. parent-guarantor as the true obligor of the Eurobonds for federal tax purposes.\textsuperscript{36} This risk of recharacterization resulted from the limited activities of a finance subsidiary, its lack of any significant independent earning power, and the absence of any substantial business purpose other than the avoidance of the U.S. withholding tax.\textsuperscript{37} Such a recharacterization could subject the amount of interest paid to Foreign Persons holding the Eurobonds to a U.S. withholding tax.

Finally, at the time the 1984 Act was being considered by Congress, several other uncertainties existed with regard to foreign finance subsidiaries. For example, IRS field agents were challenging on audit a number of arrangements involving Antilles Finance Subsidiaries,\textsuperscript{38} and the outcome of these challenges appeared unclear as the 1984 Act proceeded through Congress. In addition, the continuing viability of Antilles Finance Subsidiaries was called

\textsuperscript{35} See Rev. Rul. 74-464, 1974-2 C.B. 46. The IRS stated that "the mere existence of a five to one debt to equity ratio . . . should no longer be relied upon" as a basis for concluding for federal income tax purposes that debt obligations issued by a finance subsidiary represent indebtedness of the subsidiary, rather than of the U.S. parent-guarantor. \textit{Id.} at 47.

\textsuperscript{36} \textit{General Explanation of the 1984 Act}, \textit{supra} note 23, at 390.

\textsuperscript{37} For example, the IRS might argue that the U.S. parent-guarantor should be treated as the true obligor of the Eurobonds based on the theory that (a) the finance subsidiary was merely a conduit or agent of the U.S. parent with respect to the payment of principal and interest on the Eurobonds, or (b) the finance subsidiary should be disregarded as a corporate entity for such tax purposes. \textit{See, e.g.,} Aiken Industries, Inc. v. Comm'r, 56 T.C. 925 (1971), \textit{acq.}, 1972-2 C.B. 1; Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712 (5th Cir. 1972), \textit{cert. denied}, 409 U.S. 1076 (1972). \textit{See also} Moline Properties, Inc. v. Comm'r, 319 U.S. 436 (1943); Comm'r v. Bass, 50 T.C. 595 (1968). In addition, it was arguable that the creation of the finance subsidiary should be viewed as having the avoidance of U.S. withholding tax as its principal purpose so that the exemption from withholding tax would not apply under Code \textsection{269} (which permits the IRS to disallow certain tax benefits where the principal purpose of obtaining control of a corporation or creating a controlled corporation is the evasion or avoidance of federal income taxes). I.R.C. \textsection{269}.

\textsuperscript{38} At least one company, Texas International Airlines, disclosed the existence of such an audit challenge in a proxy statement. Fialka, \textit{Closing a Loophole}, Wall St. J., Oct. 11, 1982, at 18, col. 1.
into question at that time since the United States and the Netherlands Antilles were in the process of renegotiating the existing Netherlands Antilles Tax Treaty.\footnote{39}

\section*{C. Compliance Requirements of U.S. Tax Law with Respect to the Issuance of Debt to Foreign Persons}

In response to concern regarding non-compliance in the reporting of interest income, Congress enacted tax legislation in 1982 and 1983 adding new compliance provisions to the Code.\footnote{40} These provisions generally included expanded information reporting rules applicable to interest payments, the imposition of "backup withholding" in the event interest income is not reported by its recipients, and the imposition of various tax sanctions if certain types of debt obligations are issued in bearer form rather than "in registered form".

\subsection*{1. Information Reporting and Backup Withholding}

U.S. payors of "interest"\footnote{41} are required to file annual information returns with the IRS reporting payments made during any one year of $10 or more of interest to any person or entity, unless the recipient is statutorily exempt from this reporting (hereinafter an Exempt Recipient).\footnote{42} These returns include the names, addresses and taxpayer identification numbers of the

\footnote{39. Discussions to renegotiate the Netherlands Antilles Tax Treaty first commenced in 1979 and have proceeded intermittently since that time. Prior to the 1984 Tax Act, the primary goal of the United States in these negotiations appeared to have been to prevent the direct or indirect use of the favorable provisions of the Netherlands Antilles Tax Treaty by those persons who were not resident in the Netherlands Antilles. The Treasury Department has announced that it will soon resume meetings with representatives of the Netherlands Antilles in an effort to draft a new tax treaty between the United States and the Netherlands Antilles. In this regard, the Treasury Department has acknowledged that the repeal of the withholding tax on interest contained in the 1984 Tax Act will significantly change the atmosphere in which the negotiations will take place. Tax Treaties: Talks with Antilles to Resume, Treasury Officials Say, DAILY TAX REP. (BNA) No. 95 at G-1 (May 16, 1985).}


\footnote{41. I.R.C. § 6049(b) specifically defines the term "interest" for purposes of these information reporting requirements.}

\footnote{42. I.R.C. § 6049(a)(1). Except to the extent otherwise provided in the Treasury Regulations, Exempt Recipients include the following persons or entities:

1. corporations;
2. organizations which have tax exempt status under § 501(a) of the Code (e.g., charitable organizations, qualified pension, profit-sharing and other requirement trusts) or individual retirement accounts;
3. securities and commodities dealers required to register as such under the laws of the United States or a State;
4. real estate investment trusts;
5. entities registered at all times during the year under the Investment Company Act of 1940 (i.e., mutual funds);
6. certain governmental entities and trust funds;
7. nominees or custodians; and}
payees and the aggregate amount of interest paid. While the payment of interest to a custodian, nominee or other agent of the payee (hereinafter a Middleman) is exempt from information reporting, a Middleman who remits this interest to the beneficial owners thereof generally must file information reports with respect to such payment.

These reporting requirements, however, generally do not apply to payments of interest to Foreign Persons which either:

1. are subject to U.S. withholding tax with respect to such interest, or
2. would be subject to U.S. withholding tax but for the fact that (a) the interest constitutes foreign source income (i.e., does not constitute U.S. Source Interest), (b) the interest is exempt from such tax by reason of a Tax Treaty, or (c) the interest constitutes original issue discount.

In addition, foreign payors generally are not required to report payments to Foreign Persons which are treated as interest from sources outside the United States (e.g., interest paid by a foreign corporation less than 50 percent of whose aggregate worldwide gross income during a specified period is Effectively Connected Income).

In order to improve compliance with U.S. tax laws, Congress also added to the Code so-called “backup withholding” provisions which apply to payments of interest subject to the information reporting rules discussed above. These provisions require payors of interest to withhold 20 percent of the amount of such interest payments if:

1. the payee fails to furnish its taxpayer identification number to the payor in the manner required; or
2. the IRS notifies the payor that the taxpayer identification number furnished by the payee is incorrect; or
3. the IRS notifies the payor that backup withholding should commence because the payee has failed to properly report his receipt of interest; or
4. when required to do so, the payee fails to certify, under penalties of perjury, that he is not subject to backup withholding by reason of a specific statutory exemption.

As noted above, the Code does not impose information reporting or backup withholding with respect to interest paid to Foreign Persons if a U.S. withholding tax would be imposed on the payment but for a statutory or Tax Treaty exemption. Prior to the 1984 Act, for example, this provision exempted from information reporting and backup withholding interest paid to Foreign Persons by an Antilles Finance Subsidiary of a U.S. corporation.

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(8) any person or entity (including a financial institution or broker) who collects any interest for the payee or otherwise acts as a “middleman” between the payor and payee.

43. I.R.C. § 6049(a).
44. I.R.C. § 6049(a)(2).
45. I.R.C. § 6049(b)(2)(C), (b)(5).
46. I.R.C. § 6049(b)(2)(D).
47. I.R.C. § 3406.
In some cases, however, the applicable Treasury Regulations required Foreign Persons receiving interest from U.S. payors to certify to the payors that they were not U.S. citizens or residents or U.S. corporations, partnerships, trusts or estates (hereinafter U.S. Persons).\(^\text{49}\) Such certification was necessary in order to avoid the information reporting and backup withholding requirements for such payments.\(^\text{50}\) Prior to the 1984 Act, for example, interest paid to a Foreign Person outside the United States with respect to a deposit with a U.S. bank, savings and loan association or similar institution (interest which was statutorily exempt from the U.S. withholding tax) appeared to be subject to information reporting and backup withholding unless the payee certified its status as a Foreign Person in writing to the payor.\(^\text{51}\) In contrast, no such certification was necessary with respect to interest paid to Foreign Persons outside the United States on debt obligations issued by 80/20 Corporations,\(^\text{52}\) Antilles Finance Subsidiaries,\(^\text{53}\) or foreign branches of U.S. financial institutions,\(^\text{54}\) absent actual knowledge by the payor that a payee was not a Foreign Person.

Information reporting and backup withholding were also applicable to payments of principal,\(^\text{55}\) and the same exemptions noted above with respect to payments to, or by, Foreign Persons were also applicable to such payments.\(^\text{56}\)

2. **Issuance of Debt “In Registered Form”**

Subject to certain specific statutory exemptions,\(^\text{57}\) a debt offered to the public and issued by a corporation or the U.S Government after December 31, 1982 with an original maturity of one year or more (hereinafter a Registration-Required Obligation)\(^\text{58}\) must be issued “in registered form”\(^\text{59}\) to avoid the imposition of U.S. tax sanctions on the issuer and holders of the obligations (hereinafter the Registration Requirements).\(^\text{60}\)

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\(^{49}\) For the statutory definition of U.S. Person, see I.R.C. §§ 7701(a)(30) and I.R.C. §§ 7701(a)(4), 7701 (a)(31) and 7701(b).


\(^{52}\) See supra note 17 and accompanying text.

\(^{53}\) See supra notes 26–33 and accompanying text.


\(^{55}\) I.R.C. §§ 6045, 3406.


\(^{57}\) See text accompanying infra notes 63–65.

\(^{58}\) I.R.C. § 163(f)(2).

\(^{59}\) A Registration-Required Obligation will be treated as issued “in registered form” if either (1) the obligation is registered as to both principal and any stated interest and transfer of the obligation may be effected only by the surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder, or (2) the right to principal of, and stated interest on, the obligation may be transferred only through a “book-entry” system consistent with applicable Treasury Department regulations. See Treas. Reg. § 5f.103-1(c) (1982).

\(^{60}\) I.R.C. § 163(f). The following tax sanctions are imposed on a corporation which issues a Registration-Required Obligation in bearer form: (1) no interest deduction is allowable to the
long-term debt obligations became part of the Code pursuant to the Tax Equity and Fiscal Responsibility Act of 1982 (hereinafter the TEFRA). Congress believed at that time that a fair and efficient system of information reporting and withholding could not be achieved with respect to interest-bearing obligations as long as issuers continued to offer a significant volume of debt obligations in bearer form. Congress further believed that a registration system would reduce the ability of non-complying taxpayers to avoid reporting income for federal income tax purposes.

For Eurobonds, however, TEFRA provided a special statutory exemption to the Registration Requirements (hereinafter the Eurobond Registration Exemption), in recognition of the fact that the Eurobond market is largely a "bearer market". Under this exemption, no tax sanctions will be imposed with respect to a debt obligation issued in bearer form if all of the following requirements (hereinafter collectively referred to as the Eurobond Registration Exemption Requirements) are satisfied:

1. the obligation is issued pursuant to arrangements reasonably designed to ensure that it will be sold (or resold in connection with its original issuance) only to a Foreign Person;
2. interest on the obligation is payable only outside of the United States and its possessions; and
3. the face of the obligation contains a statement that any U.S. Person who holds the obligation will be subject to certain sanctions under the U.S. income tax laws.

TEFRA, however, also gave the Treasury Department authority to require registration of certain debt obligations designed for sale in foreign markets if the Treasury Department determined that such obligations were being used to avoid federal income taxes. In 1982 and 1983, the Treasury Department promulgated temporary and proposed regulations prescribing the specific circumstances under which a debt obligation would qualify for this Eurobond Registration Exemption.

61. TEFRA, supra note 40.
WITHHOLDING TAX REPEAL

D. Applicability of U.S. Estate Tax to Eurobond Debt Held by Foreign Persons

Prior to the 1984 Act, individuals who were neither citizens nor domiciliaries of the United States were not subject to federal estate tax liability with respect to: (1) debt obligations of foreign corporations, (2) debt obligations of 80/20 Corporations, or (3) debt obligations of U.S. banks and savings and loan associations. Thus, no federal estate tax liability existed in the case of a debt obligation issued by a foreign finance subsidiary of a U.S. corporation and held by a Foreign Person.

III.
THE 1984 ACT AND THE TEMPORARY REGULATIONS RELATING TO PAYMENT OF U.S. SOURCE INTEREST AND PRINCIPAL TO FOREIGN PERSONS

A. Repeal of U.S. Withholding Tax on “Portfolio Interest” Paid to Foreign Persons

The legislative history of the 1984 Act reveals the importance Congress attached to the access of U.S. businesses and the U.S. Government to the Eurobond market as a source of capital. Congress concluded that the imposition of a U.S. withholding tax on certain interest paid by U.S. Persons to Foreign Persons significantly restricted this access. Recognizing that U.S. corporations sometimes incurred additional financing costs by issuing debt obligations in the Eurobond market through finance subsidiaries, Congress determined that the tax-free access of U.S. Persons to the Eurobond market should be direct.

Accordingly, section 127 of the 1984 Act generally repeals the imposition of all U.S. withholding taxes on U.S. Source Interest paid to Foreign Persons with respect to debt obligations issued after July 18, 1984, if the interest constitutes “portfolio interest” within the meaning of the 1984 Act (hereinafter Portfolio Interest). Interest paid on debt obligations issued

68. GENERAL EXPLANATION OF THE 1984 ACT, supra note 23, at 391-393.
69. For a definition of Foreign Persons, see text accompanying supra note 2.
70. Section 127 of the 1984 Act added sections 871(h) and 881(c) to the Code effective generally for interest received by Foreign Persons after July 18, 1984 with respect to debt obligations “issued” after that date. Section 127(g)(1) of the 1984 Act. Neither the 1984 Act nor the Temporary Regulations provide any specific guidance regarding when an obligation will be considered to be “issued” for this purpose. However, the Conference Committee Report on the 1984 Act states that the withholding tax repeal does not apply to interest paid on a debt obligation issued by a finance subsidiary prior to July 18, 1984 and assumed by a U.S. corporation after that date (i.e., the assumption by the U.S. corporation will not be considered the issuance of a new obligation for purposes of Section 127 of the 1984 Act). H.R. REP. NO. 861, 98th Cong., 2d Sess., 937 (1984). It would appear that the rules existing under Code section 1001 regarding the circumstances under which a change in the terms of a debt obligation is deemed to constitute the
prior to July 18, 1984 is not exempt from U.S. withholding tax. Consequently, this withholding tax will continue to be imposed where a U.S. corporation assumes debt obligations issued by a finance subsidiary on or before July 18, 1984.

At the same time, Congress recognized that repeal of the U.S. withholding tax on interest would increase the worldwide volume of outstanding bearer obligations and create potential tax compliance problems with respect to U.S. Persons. For example, a U.S. Person could attempt to buy bearer debt obligations issued by a U.S. corporation in the Eurobond market claiming to be a Foreign Person. In the absence of a U.S. withholding tax on the interest paid on these bearer obligations, the U.S. Person could fail to declare this interest on its federal income tax return without the risk that its ownership of the obligation would be discovered by the IRS. Accordingly, concurrent with the repeal of the U.S. withholding tax on interest, Congress imposed certain restrictions on the definition of Portfolio Interest to minimize federal income tax avoidance.

1. Definition Of "Portfolio Interest"

The withholding tax repeal contained in section 127 of the 1984 Act applies only to Portfolio Interest. The term Portfolio Interest generally includes interest paid on the following two types of debt obligations: (1) an obligation issued in bearer form which does not constitute a Registration Required Obligation because it satisfies the Eurobond Registration Exemption; and (2) an obligation issued "in registered form" with respect to which the person who would otherwise be required to withhold tax from interest paid on the obligation (hereinafter a Withholding Agent) has received a written exchange of this obligation for a new debt obligation would be relevant in this regard. See infra note 136 and accompanying text.

Repeal of the 30 percent U.S. withholding tax makes it unnecessary for U.S. corporations to continue to utilize Antilles Finance Subsidiaries to issue Eurobonds and the future use of the Netherlands Antilles as an international financial center is likely to decline substantially. Offshore financing activities currently generate a large portion of the Netherlands Antilles budget. See GENERAL EXPLANATION OF THE 1984 ACT, supra note 23, at 392. While recognizing the need of the IRS to closely scrutinize offshore financings so that Tax Treaties are not used to avoid federal income taxes, Congress believed that the Netherlands Antilles should have some time to adjust to the effects this legislation would have on its economy. See S. REP. NO. 169, 98th Cong., 2d Sess., 421 (1984); GENERAL EXPLANATION OF THE 1984 ACT, supra note 23, at 392–393. The legislative history of the 1984 Act suggests that the July 18, 1984 effective date of section 127 reflected Congress' concern that extension of the repeal of the U.S. withholding tax to pre-existing debt obligations would create a financial crisis in the Netherlands Antilles by making likely the immediate liquidation of existing Antilles Finance Subsidiaries.

72. Id. at 393.
73. I.R.C. §§ 871(h), 881(c)(2), (3).
statement containing certain information assuring the Withholding Agent that the beneficial owner of the obligation is not a U.S. Person.\textsuperscript{75}

2. \textit{Exceptions To "Portfolio Interest"}

In addition to these general rules, the 1984 Act and the Temporary Regulations specifically except from the definition of Portfolio Interest certain interest which would otherwise qualify as Portfolio Interest. The following subsections discuss these exceptions.

\textbf{a. Interest Received by a Ten Percent Shareholder or Partner}

Portfolio Interest does not include interest received by a Foreign Person owning (actually or constructively pursuant to specific constructive ownership rules) at least a 10 percent equity interest in the U.S. payor.\textsuperscript{76} Interest paid by a U.S. corporation does not constitute Portfolio Interest if the recipient owns (actually or constructively) at least 10 percent of the total combined voting power of all classes of stock of the payor corporation entitled to vote.\textsuperscript{77} Portfolio Interest also does not include interest paid by a U.S. partnership to a Foreign Person who owns (actually or constructively) a 10 percent or more interest in the capital or profits of the partnership.\textsuperscript{78}

Congress recognized that some taxpayers might attempt to circumvent this 10 percent ownership exception by entering into "back-to-back" loan arrangements whereby a foreign affiliate of a U.S. taxpayer lends money to an unrelated Foreign Person that relends the money at a discount to the U.S. taxpayer. In this situation, and in others where appropriate, Congress directs the IRS to determine whether back-to-back loans exist and to adopt appropriate remedies.\textsuperscript{79}

\textbf{b. Interest Received by Foreign Banks}

Interest received by a foreign bank on an extension of credit pursuant to a loan agreement entered into in the ordinary course of its banking business

\textsuperscript{75} I.R.C. § 871(h)(2)(B). This statement may be made by either the beneficial owner of the obligation or a securities clearing organization, bank, or other financial institution that holds customers' securities in the ordinary course of its business. A statement will not satisfy the requirement noted in the text if, at least one month before the interest payment involved, the Treasury Department publishes a determination that a statement from the payor (or any class including such person) will not satisfy the requirement. I.R.C. § 871(h)(4).

\textsuperscript{76} I.R.C. §§ 871(h)(3)(A), 881(c)(3)(B).


\textsuperscript{78} I.R.C. § 871(h)(3)(B)(ii). In determining whether a Foreign Person owns the requisite 10 percent or more capital or profits interest, the Treasury Department may prescribe through regulations constructive ownership rules similar to those that apply in determining 10 percent stock ownership in a corporation. I.R.C. § 871(h)(3)(C).

also does not qualify as Portfolio Interest.\textsuperscript{80} The Treasury Department expects to promulgate regulations to determine when interest paid to a foreign bank remains subject to a U.S. withholding tax under this exception (e.g., these regulations presumably will provide definitions of the terms "bank" and "loan agreement" for purposes of this exception). At this time, however, neither interest received by a foreign bank on obligations of the U.S. Government nor interest on a debt obligation issued by a U.S. Person and held by a foreign bank as an investment asset falls within this statutory exception, and both types of interest therefore qualify as Portfolio Interest.\textsuperscript{81}

c. Interest Received by a Controlled Foreign Corporation from a Related Person

Portfolio Interest also does not include interest paid by a "related person"\textsuperscript{82} to a foreign corporation at least 50 percent of whose outstanding voting power is owned or controlled by U.S. individuals or entities owning at least 10 percent of such voting power (hereinafter a Controlled Foreign Corporation). Interest paid to a Controlled Foreign Corporation by a person other than a "related person" will constitute Portfolio Interest to which no withholding tax applies.\textsuperscript{83}

d. Inadequate Exchange of Information

In addition to these specific statutory exceptions to the definition of Portfolio Interest, the 1984 Act authorizes the Treasury Department to deny the benefits of the withholding tax repeal to U.S. Source Interest paid to, or for the account of, investors in a particular foreign country if the Treasury Department determines that the exchange of information between the United States and that country is inadequate to prevent tax evasion by U.S. Persons. The Treasury Department may publish a statement indicating the identity of

\textsuperscript{80} I.R.C. § 881(c)(3)(A). In addition to addressing a Federal Reserve concern regarding reserve requirements, this foreign bank exception was intended to prevent U.S. banks (which are subject to federal income tax on their interest income) from suffering a comparative disadvantage with respect to foreign banks that loan funds to U.S. Persons. \textit{General Explanation of the 1984 Act}, supra note 23, at 395.

\textsuperscript{81} \textit{General Explanation of the 1984 Act}, supra note 23, at 395. With respect to the exception for ten-percent owners discussed in the text accompanying supra notes 76–79, Congress expressed concern that foreign banks could avoid this statutory exception to Portfolio Interest through the use of back-to-back loans and directed that the IRS address this situation. See \textit{General Explanation of the 1984 Act}, supra note 23, at 395.

\textsuperscript{82} For this purpose the term "related person" is specifically defined to mean: (1) any person who is a "related person" within the meaning of I.R.C. § 267(b), (2) any "United States shareholder" within the meaning of I.R.C. § 951(b), and (3) any person who is a "related person" to a "United States shareholder" within the meaning of I.R.C. § 267(b). I.R.C. § 864(d)(4).

\textsuperscript{83} I.R.C. § 881(c)(3)(C). However, to prevent U.S. Persons from indirectly taking advantage of the withholding tax repeal, the 1984 Act provided that Portfolio Interest received by a Controlled Foreign Corporation from an unrelated person is includible in the gross income of the corporation's U.S. shareholders under subpart F of the Code without regard to any of the exceptions otherwise provided under the subpart F rules. I.R.C. § 881(c)(4). \textit{See also} I.R.C. § 954(b), (c).
the foreign countries affected by this provision and the period of time for which the withholding tax repeal is not applicable to interest paid to a Foreign Person resident in that foreign country. Any denial of exemption from U.S. withholding tax under this exception would apply only to obligations issued after the Treasury Department's publication of this written statement.

e. Registration-Required Obligations

As originally issued in August 1984, the Temporary Regulations contain an exception to the qualification of certain interest as Portfolio Interest which is not contained in the 1984 Act itself. This regulatory exception has been the subject of extensive criticism by commentators on the Temporary Regulations because it appears contrary to the express language of section 127 of the 1984 Act, inconsistent with the legislative history and the Congressional intent of the 1984 Act, and unsupported by sound tax policy reasons. As discussed below, this criticism resulted in amendments to the Temporary Regulations in August 1985 to address one of the primary areas of concern.

Section 127 of the 1984 Act provides that interest paid on a debt obligation issued in bearer form can qualify as Portfolio Interest if the obligation is "described in section 163(f)(2)(B)", the statutory provision containing the Eurobond Registration Exemption Requirements. Section 163(f)(2)(B) of the Code in turn provides that debt obligations are "described in this subparagraph" if the issuance of the obligations satisfies the Eurobond Registration Exemption Requirements. In the case of debt obligations issued in registered form, section 127 of the 1984 Act merely provides a withholding tax exemption for any registered obligations issued after July 18, 1984, provided the applicable certification requirements are satisfied.

The Temporary Regulations take the position that interest paid on a debt obligation issued in bearer form can qualify as Portfolio Interest only if the obligation would constitute a Registration-Required Obligation except for the fact that it "is described in section 163(f)(2)(B)." Further, interest paid on a debt obligation issued in registered form can qualify as Portfolio Interest only if the obligation constitutes a Registration-Required Obligation "without regard to whether the obligation is described in section 163(f)(2)(B). . . ." Consequently, the Temporary Regulations expressly provide that interest paid on certain obligations does not qualify as Portfolio Interest, including: (a) an obligation issued by a natural person; (b) an obligation with an original maturity of one year or less; or (c) an obligation of a type not offered to the

84. As of October 1985, the Treasury Department has not published such a statement.
85. I.R.C. §§ 871(h)(5), 881(c)(5).
86. See infra notes 99-103 and accompanying text.
87. See supra note 63 and accompanying text.
88. See supra note 63 and accompanying text.
89. See infra notes 90-92 & 200-223 and accompanying text.
public (within the meaning of the statutory exceptions to the definition of a Registration-Required Obligation). The Temporary Regulations take this position even if these obligations are issued under procedures complying with the Eurobond Registration Exemption Requirements (i.e., if these obligations are of the type “described” in section 163(f)(2)(B) of the Code) or if they are issued to Foreign Persons “in registered form”.

This regulatory limitation on the definition of Portfolio Interest serves to exclude from the new withholding tax repeal interest paid on a significant number of debt obligations which are purchased by Foreign Persons. As noted above, under the Temporary Regulations interest paid on debt obligations issued by natural persons does not qualify as Portfolio Interest. In commenting on the Temporary Regulations, representatives of the securities and housing industries expressed serious concern that this restriction would cause interest paid to Foreign Persons on various types of mortgage pass-through securities to continue to be subject to the withholding tax. The representatives asserted that this result could have a significant adverse effect on both the sale of mortgage pass-through securities to Foreign Persons and on the housing industry in the United States in general.

In recent years, financial institutions have liquidated large portions of their existing mortgage portfolios by selling mortgage pass-through securities to the public. The financial institutions typically transfer title of a group of mortgages (a “pool”) to a trustee of a trust in exchange for certificates of beneficial interest in the trust. These certificates are then sold publicly. Monthly payments of principal (including prepayments) and interest on the mortgages included in the pool are “passed through” (i.e., distributed) to the certificate holders on a current basis.

91. See supra note 58. Even though individuals may be partners in a partnership, interest paid on the debt obligation of a partnership should be treated as Portfolio Interest. This conclusion is supported by the fact that a partnership is not a “natural person” and by the statutory provision excepting from the definition of Portfolio Interest interest paid by a partnership to certain partners (thereby implying that interest paid by a partnership to other partners may qualify as Portfolio Interest). See I.R.C. § 881(h)(3)(B) and supra note 78.

92. See supra note 63 and accompanying text.

93. In general, mortgage pass-through securities are securities evidencing an undivided beneficial ownership interest in a “pool” of residential mortgages whose obligors are natural persons.

94. See, e.g., Letter from The First Boston Corporation to the Commissioner of Internal Revenue (October 22, 1984); Letter from the Mortgage Bankers Association of America to the Commissioner of Internal Revenue (January 10, 1985); Letter from the National Association of Home Builders to the Commissioner of Internal Revenue (January 14, 1985); Letter from the National Council of Savings Institutions to the Commissioner of Internal Revenue (October 19, 1984). (Copies of these letters and the other letters of commentators cited herein are available from the International Tax and Business Lawyer.)

95. It is estimated that approximately 40 percent of the $190 billion of one-to-four-family residential mortgages originated in 1983 were pooled or otherwise transformed into mortgage securities. Hu, The Revolution in “Securitizing” Residential Mortgages, 14 REAL EST. REV. 42, 45 (Summer 1984).
the U.S. Government to increase the liquidity of residential mortgages: the Federal National Mortgage Association (hereinafter the FNMA); the Government National Mortgage Association (hereinafter the GNMA); or the Federal Home Loan Mortgage Corporation (hereinafter the FHLMC). For federal income tax purposes, the IRS historically has treated this mortgage pass-through arrangement as a "grantor trust," treating the holders of the certificates of beneficial interest as owning a pro rata interest in each of the underlying mortgages in the pool.96

Consistent with this "grantor trust" treatment, it initially appeared that Foreign Persons owning mortgage pass-through securities might be treated for federal income tax purposes as receiving interest on debt obligations issued by natural persons and that this interest, therefore, would not qualify as Portfolio Interest under the Temporary Regulations. As issued in August 1984, the Temporary Regulations did not specifically address the application of section 127 of the 1984 Act to interest paid on mortgage pass-through securities. Numerous comments were filed with the Treasury Department in opposition to the apparent exclusion of interest paid on mortgage pass-through securities from the definition of Portfolio Interest. These comments generally expressed the view that the position taken in the Temporary Regulations was contrary to the express language of section 127 of the 1984 Act, inconsistent with Congressional intent in repealing the withholding tax on interest, and inconsistent with the Government's policy of improving and expanding the residential mortgage markets.97 In apparent response to these comments and in recognition of the position taken in the Temporary Regulations to the contrary, the Joint Committee on Taxation subsequently stated its belief that Congress intended that interest on publicly traded mortgage pass-through securities would qualify as Portfolio Interest so as to be eligible for the exemption from the U.S. withholding tax provided by the 1984 Act. In this regard, the Joint Committee on Taxation also indicated that Congress considered these securities to be Registration-Required Obligations.98


97. See supra note 94.

98. GENERAL EXPLANATION OF THE 1984 ACT, supra note 23, at 396. In determining whether an interest in certain intermediate investing entities (e.g., mortgage pass-through trusts) is a Registration-Required Obligation under TEFRA, the Joint Committee on Taxation takes the position that the relevant inquiry is the nature of the interest itself and that liquid and actively traded securities are Registration-Required Obligations. Since mortgage pass-through securities are liquid, actively traded, and readily negotiable for cash, the Joint Committee on Taxation considers them to be subject to the Registration Requirements. However, the Joint Committee also stated that the determination of the applicability of the Registration Requirements with reference to mortgage pass-through securities, rather than to the underlying mortgages, does not
In view of the uncertainty regarding the qualification as Portfolio Interest of interest paid on mortgage pass-through securities and the consequent inability of mortgage bankers to sell such securities to Foreign Persons, the Treasury Department's August 1985 amendments to the Temporary Regulations specifically address this issue. As amended, the Temporary Regulations now expressly provide that interest paid to a holder of a "pass-through certificate" will qualify as Portfolio Interest if (1) all of the conditions set forth in the Temporary Regulations applicable to bearer and registered debt obligations are satisfied with respect to the certificate (even if these conditions are not satisfied with respect to the obligations held by the issuer of the pass-through certificate to which the certificate relates), and (2) all of the obligations held by the issuer of the pass-through certificate to which the certificate relates are issued after July 18, 1984.99 For this purpose, interest is considered to be paid on or with respect to the pass-through certificate and not on or with respect to any obligations held by the issuer of the pass-through certificate. The Temporary Regulations therefore now provide that, solely for purposes of the definitions of Portfolio Interest with respect to bearer debt obligations, a pass-through certificate is considered to be an obligation that would be a Registration-Required Obligation except for the fact that it "is described in section 163(f)(2)(B)"100 if (1) the pass-through certificate itself is a Registration-Required Obligation, and (2) the certificate itself is issued in accordance with the Eurobond Registration Exemption.101 For purposes of these new rules, a "pass-through certificate" is generally defined as a pass-

imply that interest income distributed by a mortgage pass-through trust can qualify as Portfolio Interest where the underlying mortgages originated before July 18, 1984 (i.e., the effective date of the withholding tax repeal). Id.

In comments submitted on the August 1984 version of the Temporary Regulations, savings and loan associations have formally taken the position that interest paid on mortgage pass-through securities issued after July 18, 1984 should be exempt from U.S. withholding tax, even if one or more mortgage loans in the pool were originated before July 19, 1984. See Letter from Mr. Phil Gasteyer, Executive Director of Washington Operations and Coley O'Brien, Esq., Vice President and Legislative Counsel, on behalf of the United States League of Savings Institutions to Mr. Ronald A. Pearlman, Assistant Secretary for Tax Policy, Department of the Treasury (May 1, 1985) [hereinafter cited as Gasteyer Letter]. As Registration-Required Obligations, the Joint Committee on Taxation noted that mortgage pass-through securities must satisfy the Eurobond Registration Exemption Requirements. See supra note 63 and accompanying text.


100. See supra note 90 and accompanying text.

WITHHOLDING TAX REPEAL

through or participation certificate evidencing an interest in a pool of mortgage loans which is treated as a "grantor trust" for federal income tax purposes. The new rules discussed above will permit sales of pass-through certificates to Foreign Persons and should result in a significant number of such sales in the near future.

In addition, the Temporary Regulation's definition of Portfolio Interest affects debt obligations with a maturity of between six months and one year (e.g., commercial paper and short-term U.S. Treasury Bills). Comments submitted to the Treasury Department assert that the position taken in the Temporary Regulations in this regard discriminates unnecessarily against short-term obligations (other than deposits in financial institutions) and that the continued subjection of the interest on these obligations to a withholding tax is inconsistent with Congress' goal of increasing efficient access to foreign capital markets by U.S. businesses and the U.S. Government. In this connection interest paid to Foreign Persons on deposit obligations issued by banks, savings and loan associations, and similar financial institutions and discount on obligations with original maturities of six months or less are not affected by the restrictive position in the Temporary Regulations since this interest is exempt from U.S. withholding tax (as it was prior to the 1984 Act) without regard to its qualification as Portfolio Interest. The Temporary Regulations therefore perpetuate the tax advantages to Foreign Persons of investing in short-term deposit obligations and short-term discount obligations with original maturities of six months or less in lieu of other short-term corporate or governmental obligations.

Finally, commentators have also criticized the Temporary Regulations' exclusion from Portfolio Interest of interest payable on debt obligations "not of a type offered to the public." A major issue in this regard concerns the

102. The Temporary Regulations also include within the definition of a "pass-through certificate" a "similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust." Temp. Treas. Reg. § 1.163-5T(d)(1), T.D. 8046, 50 Fed. Reg. 33,525 (1985).


104. See supra note 90 and accompanying text, concerning the exclusion from Portfolio Interest of interest paid on corporate debt with an original maturity of one year or less. Original issue discount paid to Foreign Persons on debt obligations with an original maturity of 183 days or less is not subject to federal income taxation. I.R.C. §§ 871(g)(1)(B), 881(a)(3).

105. See, e.g., Letter from Nicholas A. Rey, Managing Director, Investment Banking Division, Merrill Lynch Capital Markets, to the Commissioner of Internal Revenue (October 22, 1984); Outline of Remarks of Mr. Richard L. Grand-Jean, Managing Director, Salomon Brothers Inc. at Hearing of January 28, 1985 Concerning Temporary TEFRA and Withholding Tax Repeal Regulations (January 14, 1985).

106. See I.R.C. §§ 861(a)(1)(C), 871(g)(1)(B), 881(a)(3). See also supra note 14 and accompanying text.

107. See, e.g., Letter from Thomas S. Saunders, III, Managing Director of Morgan Stanley & Co., to Mr. Ronald A. Pearlman, Acting Assistant Secretary for Tax Policy, Department of the Treasury (October 31, 1984) [hereinafter cited as Saunders Letter].
fact that neither the Code nor the Temporary Regulations provides any definitive guidance as to whether debt obligations sold in a "private placement" and exempt from federal securities registration can constitute obligations "of a type offered to the public." Temporary regulations issued by the Treasury Department in November 1982 with respect to the Registration Requirements state that the question of whether an obligation is of a type offered to the public is determined by whether "similar obligations" are in fact publicly offered or traded. Therefore, the eligibility of interest on privately-placed debt obligations under the Temporary Regulations depends on the result of this indefinite test.

In testimony before the House Ways and Means Committee during recent hearings on a bill to make technical corrections to the 1984 Act, the Treasury Department proposed that the language of the 1984 Act be amended to clarify that the U.S. withholding tax repeal applies only to interest on debt instruments that are publicly offered and traded abroad and does not apply to trade indebtedness and privately-placed obligations. Members of the House Ways and Means Committee reacted adversely to this Treasury Department proposal mainly because the Committee apparently intended to exempt from withholding tax interest on both public and private offerings.

108. Temp. Treas. Reg. § 5f 1.163-1(b)(2)(1982). An example in this temporary regulation involves the placement by a closely-held corporation of its convertible debentures with 30 individuals. The offering is not required to be registered under the Securities Act of 1933 and similar debentures are publicly offered and traded. This example concludes that the convertible debentures are of a type offered to the public. Temp. Treas. Reg. § 5f 1.163-1(b)(2)(f), Ex. 5 (1982).


110. Technical Corrections Act of 1985: Hearings on H.R. 1800 Before the Comm. on Ways and Means, 98th Cong., 2d Sess. (1985) (statement of J. Roger Mentz, Deputy Assistant Secretary (Tax Policy), Department of the Treasury). The Treasury Department cited the following two reasons as support for its proposal: (1) the policy basis for exempting from U.S. withholding tax interest paid on publicly-traded debt obligations (i.e., to facilitate the transfers of Eurobond obligations in the secondary market to Foreign Persons resident in a country which does not have a Tax Treaty with the United States which exempts interest income from U.S. withholding tax) does not apply to trade indebtedness and privately-placed debt obligations; and (2) other countries generally have not repealed their respective withholding taxes on interest paid on such obligations. See also Treas. News Bull. 141 (May 16, 1985).

111. See Technical Corrections: Treasury Suggests Limiting Repeal of 30-Percent Withholding to Public Placements, Daily Tax Rep. (BNA) No. 96, at G-9, 10 (May 17, 1985). The Treasury Department's proposal to continue the U.S. withholding tax on privately-placed debt obligations and on trade indebtedness also has been criticized by members of the tax bar. See, e.g., Letter from Joseph H. Guttentag, Esq., to J. Roger Mentz, Deputy Assistant Secretary (Tax Policy), Department of the Treasury (June 12, 1985); Letter from Peter E. Baumbusch, Esq. and Daniel Q. Callister, Esq. to Congressmen Gibbons and Rostenkowski and J. Roger Mertz, Deputy Assistant Secretary (Tax Policy), Department of the Treasury (July 12, 1985) [hereinafter cited as Baumbusch Letter]. The Treasury Department's proposal was not adopted in the bill passed by the House of Representatives in December 1985 making technical corrections to the 1984 Act. See H.R. 3838, 99th Cong., 1st Sess., § 1510(d)(3), 131 Cong. Rec. H12703 (daily ed. Dec. 17, 1985).

The Treasury Department has contended that the intentions of the Senate sponsors of the legislation repealing the U.S. withholding tax regarding the scope of the repeal are unclear. The Treasury Department has also now acknowledged that the resolution of this question involves a
As reflected in the comments discussed above, the restrictive definition of Portfolio Interest contained in the Temporary Regulations appears to be contrary to the express language of section 127 of the 1984 Act, inconsistent with the legislative history of the 1984 Act and the Congressional intent in repealing the withholding tax on interest, and unsupported by sound tax policy reasons. Further, it is unlikely that Congress intended to

112. With respect to debt obligations issued in both bearer and registered form, section 127 of the 1984 Act defines Portfolio Interest to mean interest paid on any obligation which "is described in section 163(f)(2)(B)" of the Code. See supra note 63 and accompanying text. This statutory provision sets forth the Eurobond Registration Exemption Requirements (i.e., the procedures which must be followed in order for a debt obligation to be sold to a Foreign Person in bearer form without subjecting the issuer to any tax sanctions). Section 127 of the 1984 Act does not make any reference to § 163(f)(2)(A) of the Code (i.e., the provision setting forth the three types of obligations which do not constitute Registration-Required Obligations). If Congress had intended to impose additional restrictions on the definition of Portfolio Interest, it certainly could have done so specifically. Further, the definition of Portfolio Interest contained in the Temporary Regulations is inconsistent with the statutory exception to Portfolio Interest for interest received by a foreign bank pursuant to a business loan. See I.R.C. § 881(c)(3)(A). Since such business loans are not likely to constitute obligations "of a type offered to the public," these loans are not Registration-Required Obligations. Therefore, this specific foreign bank exception to the Portfolio Interest definition contained in section 127 of the 1984 Act would be surplusage under the approach adopted by the Temporary Regulations. It is not likely that Congress intended this result. See, e.g., Memorandum from Simpson, Thatcher & Bartlett to the Commissioner of Internal Revenue (Oct. 21, 1984).

113. The report of the Senate Finance Committee relating to section 127 of the 1984 Act provides that debt "of any U.S. issuer, not just debt of U.S. corporations, may fall into this category (eligibility for the withholding tax exemption)." This statement of Congressional intent is clearly contrary to the Temporary Regulations' refusal to extend the withholding tax exemption to the debt obligations of a "natural person", even though such a person might be a "U.S. issuer". S. REP. NO. 169, 98th Cong., 2d Sess. 421 (1984). Moreover, various legislative proposals for repeal of the U.S. withholding tax on interest have been considered by Congress since 1975. See, e.g., H.R. 10612, 94th Cong., 1st Sess., 121 CONG. REC. 38,281-85 (1975); H.R. 7553, 96th Cong., 2d Sess. (1980); S. 3213, 96th Cong., 2d Sess. (1980); H.R. 4618 (1981). Each of these bills was introduced years before TEFRA introduced the concept of Registration-Required Obligations into the Code. The legislative history of the 1984 Act does not indicate that Congress' latest consideration of the repeal of the withholding tax on interest was meant to introduce that concept into the scope of this repeal.

114. The inclusion of the Registration Requirements in the Code was part of an overall Congressional effort to reduce the circumstances under which persons could avoid reporting interest income received on debt obligations. See supra notes 60-62 and accompanying text. Congress clearly believed that taxpayer compliance in reporting interest income would be increased if a debt obligation was issued "in registered form". In adopting the Registration Requirements, Congress expressly exempted from these requirements the obligations contained in I.R.C. § 163(f)(2)(A). However, this relief provision to the Registration Requirements appears to have been used by the Temporary Regulations as a basis for restricting the definition of Portfolio Interest. This subjects the same debt obligations which received favored tax treatment with respect to the Registration Requirements to disfavored treatment under the 1984 Act.

115. The exclusion from the definition of Portfolio Interest of interest paid on debt obligations of one year or less would result in an anomalous situation. While discount obligations with a maturity of 183 days or less or in excess of twelve months would be exempt from the withholding tax, the Temporary Regulations would impose such a withholding tax on discount obligations (other than deposit obligations) with a maturity of from six months to one year. There is no apparent tax policy reason supporting this discriminatory treatment. Furthermore, denying an exemption from U.S. withholding tax to interest paid on privately-placed debt obligations or
exclude such broad classes of debt obligations from eligibility for the new withholding tax exemption without any discussion of such exclusion in the legislative history of the 1984 Act.\textsuperscript{116} Accordingly, the final regulations relating to the definition of Portfolio Interest should eliminate the requirement that a debt obligation constitute a Registration-Required Obligation in order for interest payable thereon to constitute Portfolio Interest. If this requirement is not eliminated in the final regulations, it may still be possible for a corporation to avoid the imposition of a U.S. withholding tax on interest paid on debt obligations which do not constitute Registration-Required Obligations by issuing these obligations to Foreign Persons through foreign finance subsidiaries.\textsuperscript{117}

3. \textit{Bearer Debt Obligations}

Where the Treasury Department determines that a particular debt obligation is of a type used frequently in avoiding federal income taxes, TEFRA empowers the Treasury Department to require by regulations that this obligation be issued in registered form even if the Eurobond Registration Exemption Requirements are satisfied with respect to the obligation.\textsuperscript{118} Because of Congressional concern that a general repeal of the withholding tax with respect to bearer debt obligations could result in new compliance problems involving U.S. Persons, section 127(f) of the 1984 Act further expands the Treasury Department's authority to require registration of debt obligations to be sold to Foreign Persons. Accordingly, the 1984 Act grants the Treasury Department full discretion to exclude obligations from the Eurobond Registration Exemption without the need to find frequent tax avoidance usage.\textsuperscript{119}

\textit{a. U.S. Government Obligations in Bearer Form}

The Temporary Regulations prohibit the issuance or guarantee of bearer obligations, either directly or through affiliated entities, by a U.S. Government-owned agency or a U.S. Government-sponsored enterprise (e.g., FNMA, FHLMC, the Federal Loan Mortgage Corporation, the Farm Credit Administration and the Student Loan Marketing Association).\textsuperscript{120} These Regulations do not specifically indicate, however, whether deposit obligations

\begin{itemize}
\item commercial financing arrangements would discriminate against small businesses which, unlike larger businesses, cannot economically raise foreign capital through a public offering. \textit{See}, e.g., Baumbusch Letter, \textit{supra} note 111.
\item The legislative history behind section 127 of the 1984 Act discusses only the four statutory exceptions to the definition of Portfolio Interest. \textit{See supra} notes 76–85 and accompanying text.
\item However, recent I.R.S. rulings relating to the issuance of debt obligations through Antilles Finance Subsidiaries would have to be considered in any such planning. \textit{See} Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383. For a discussion of these rulings, see \textit{infra} note 140.
\item I.R.C. § 163(f)(2)(C).
\item I.R.C. § 163(f)(2)(C)(i).
\end{itemize}
insured by either the Federal Deposit Insurance Corporation (hereinafter the FDIC) or the Federal Savings and Loan Insurance Corporation (hereinafter the FSLIC) are considered to be "guaranteed" by a U.S. governmental agency for purposes of this prohibition.

Comments submitted to the Treasury Department have requested clarification of the ability of financial institutions to issue federally insured deposit obligations in bearer form.121 Commentators have expressed concern that deposit insurance issued by FDIC or FSLIC could be considered to be a "guarantee" of the depository institution's obligation by the U.S. Government. Since the Temporary Regulations contain specific provisions relating to the applicability of information reporting and backup withholding to deposit obligations issued in bearer form,122 it appears that federally insured deposit obligations should not be subject to the prohibition against the issuance of bearer obligations "guaranteed" by U.S. entities.

While permitted by the 1984 Act to issue bearer debt obligations, the Treasury Department has announced that it will continue to issue its securities only "in registered form" and that it will commence issuing registered obligations specially "targeted" for sale to Foreign Persons.123 Two issues of these "targeted" registered obligations were made by the Treasury in October and December 1984.124

The Treasury Department has indicated that it will continue to sell "targeted" registration obligations in the Eurobond market even if it does not realize any cost savings as compared with domestic debt issues.125 The

121. See, e.g., Letter from Paula D. Porpilia, Associate Tax Counsel, American Bankers Association, to the Commissioner of Internal Revenue (November 5, 1984).
123. See T.D. 7965, 1984-2 C.B. 39. The decision states: "Although the Treasury Department has the statutory authority to issue bearer obligations, it has no plans to do so. To the extent that the Treasury Department intends to issue obligations targeted to foreign purchasers, it will issue registered obligations pursuant to arrangements reasonably designed to ensure sales to non-United States persons under A-13 of Temp. Treas. Reg. § 35a.9999-5." Id. See also infra notes 196-199 & notes 219-223 and accompanying text for a discussion of these "targeted" treasury obligations.

In August 1984 Rep. Stark (D-Cal.), a member of the House Ways and Means Committee, introduced a bill in the House of Representatives to require the Treasury Department to issue its debt obligations to Foreign Persons only in registered form. H.R. 6180, 98th Cong., 2d Sess., 130 CONG. REC. H-9062 (1984). No action had been taken on this bill prior to the termination of the 98th Congress. A similar bill has now been introduced in the 99th Congress by Rep. Russo (D-Ill.). H.R. 1225, 99th Cong., 1st Sess., 131 CONG. REC. H605 (1985).
124. In the October 1984 issue, the Treasury Department sold $1 billion of notes with maturities of three years and eleven months. The Treasury Department expected to save approximately $3.2 million in annual interest costs through the issuance of these obligations in the Eurobond market, rather than in the bond market. See Wall St. J., Oct. 25, 1984, at 52, col. 4. However, the December 1984 issue resulted in substantially lower interest cost savings to the Treasury Department. U.S. to Continue Borrowing Overseas Even Without Cost Advantage, Treasury Official Says, DAILY TAX REP. (BNA), No. 51, at G-1 (March 15, 1985).
125. DAILY TAX REP., supra note 124 at G-1, -2.
Treasury Department's decision to issue Eurobond obligations solely in registered form was based on its recognition of the significant compliance problems which could result from the purchase of bearer obligations by U.S. Persons (e.g., a U.S. Person could purchase bearer Treasury obligations in the name of a Foreign Person and not report the interest income payable thereon). Until a solution to these compliance problems is found, it is unlikely that the Treasury Department will sell bearer obligations abroad.

Shortly after the enactment of the 1984 Act, the Treasury Department utilized for the first time its expanded statutory power to require the issuance in registered form of debt obligations that would otherwise be eligible to be issued in bearer form. On September 7, 1984, the Treasury Department announced that its self-imposed prohibition on the issuance of bearer obligations would also apply to debt obligations "backed by" securities issued by the Treasury Department, other U.S. Government-owned agencies and U.S. Government-sponsored enterprises and by obligations of private issuers guaranteed by the U.S. Government (hereinafter collectively referred to as U.S. Government Securities).

The Temporary Regulations, however, did not specifically address the question of whether securities backed by U.S. Government Securities (hereinafter U.S. Government-Backed Securities) may be issued in bearer form under the Eurobond Registration Exemption. After the publication of the Temporary Regulations and considerable review, Treasury concluded that a U.S. Government-Backed Security should be subject to the same registration requirements as the U.S. Government Security underlying the U.S. Government-Backed Security. The Treasury Department has announced that it will promulgate regulations requiring U.S. Government-Backed Securities issued after September 7, 1984 to be "in registered form" and prohibiting these securities from being issued to Foreign Persons in bearer form under the Eurobond Registration Exemption.

129. See supra notes 68 & 128. Examples of U.S. Government-Backed Securities include corporate debt obligations collateralized with FNMA, GNMA and FHLMC mortgage pass-through certificates.
130. TREAS. DEP'T NEWS, supra note 128.
131. These regulations have not been promulgated. After the enactment of the 1984 Act and prior to the issuance of the Temporary Regulations, certain investment bankers had substantially completed offerings of U.S. Government-Backed Securities in bearer form to Foreign Persons. Salomon Brothers, Inc., for example, had acted as lead underwriter in a $1.7 billion offering of Certificates of Accrual in Treasury Securities (hereinafter CATS), which were bearer and registered instruments backed by U.S. Government Securities. See Treasury Reassures Foreign Investors But Not Congress About Targeted Issue, 24 TAX NOTES 1103 (1984). This type of offering enabled Foreign Persons to hold the equivalent of a U.S. Government Security in a tax-free, bearer form.

On September 14, 1984, the Treasury Department announced that its September 7 announcement did not affect these issuances of U.S. Government-Backed Securities. Treas. Dept.
For purposes of these forthcoming Treasury regulations, a U.S. Government-Backed Security includes:

1. pass-through or participation certificates backed by U.S. Government Securities;
2. interests in fixed investment or grantor trusts or custodial arrangements funded with U.S. Government Securities;
3. debt obligations collateralized with U.S. Government Securities;
4. securities backed by securities guaranteed as to interest or principal by the U.S. Government;
5. other similar instruments or interests; and
6. an instrument where more than 50 percent of the income, or collateral, supporting the instrument consists of income or principal of a U.S. Government Security (including a security guaranteed as to interest or principal by the U.S. Government).

An issue arises as to whether the prohibition on the issuance after September 7, 1984 of a U.S. Government-Backed Security in bearer form applies to U.S. Government-Backed Securities issued by an Antilles Finance Subsidiary prior to September 7, 1984 and assumed (directly or indirectly) by a U.S. affiliate of the Antilles Finance Subsidiary after this date. The Treasury Department’s September 7, 1984 announcement does not provide any rules concerning what constitutes the issuance of an obligation for this purpose.

Prior to the 1984 Act, several domestic savings and loan institutions issued collateralized Eurobond obligations through Antilles Finance Subsidiaries in order to avoid possible backup withholding problems with respect to interest paid by these institutions directly to Foreign Persons. The savings and loan associations apparently had intended to eliminate the use of their Antilles Finance Subsidiaries and assume a direct obligation to the Foreign Persons acquiring the debt obligations initially issued by the finance subsidiaries if and when the backup withholding issue was resolved.

The savings and loans planned to accomplish this assumption of debt in one of two alternative ways: (1) the net proceeds of the Eurobonds issued by the Antilles Finance Subsidiaries would be loaned to the savings and loan

News Release, R-2847, Sept. 14, 1984. It is also noted that, prompted by its concern about compliance abuses, the United States Senate on August 10, 1984 (prior to the issuance of the Temporary Regulations), had passed a non-binding resolution that the Treasury Department should take action to prevent the issuance of U.S. Government-Backed Securities in bearer form. See Amend. No. 3700, 98th Cong. 2d Sess., 130 CONG. REC. S. 10448–10450 (1984).

132. See TREAS. DEP’T NEWS, supra note 128.

133. These indirect Eurobond issuances through Antilles Finance Subsidiaries were concluded because of concern that backup withholding would be imposed on payments of interest to Foreign Persons on deposit obligations issued directly by the savings and loan association in bearer form unless the association received a certificate from the Foreign Person disclosing its identity and certifying its foreign status. See supra note 51 and accompanying text. On May 15, 1984, Coast Savings and Loan Association, a California licensed mutual savings and loan association, issued $125 million in collateralized Eurobonds through an Antilles Finance Subsidiary. On August 22, 1984 Great American Savings Bank, a California licensed stock savings bank, made a similar Eurobond offering of $100 million. See Letter from David J. Grant, Esq., on behalf of Coast Savings and Loan Association and Great American First Savings Bank, to the Commissioner of Internal Revenue (October 3, 1984) [hereinafter cited as the Grant Letter].
association with the intention that the association would subsequently assume the Antilles Finance Subsidiaries’ obligations under the Eurobonds; or (2) the funds borrowed by the Antilles Finance Subsidiaries would be invested in collateralized FSLIC-insured certificates of deposit issued by the savings and loan association, with the Antilles Finance Subsidiaries retaining the right to subsequently assign its interest in these certificates of deposit to the holders of its Eurobonds in discharge of their liability thereunder. 134 These savings and loan associations submitted comments to the Treasury Department requesting that the forthcoming Treasury regulations relating to U.S. Government-Backed Securities be clarified to provide expressly that the direct or indirect assumption by these associations of the indebtedness owed by their Antilles Finance Subsidiaries to Foreign Persons would not be treated as the issuance of new debt obligations after September 7, 1984 and would be unaffected by the prohibition against the issuance of U.S. Government-Backed Securities in bearer form after that date. 135

The position taken by these savings and loan associations appears to be supported both by existing legal authority relating to the issue of whether a debt assumption results in the issuance of a new debt obligation for federal income tax purposes 136 and by sound tax policy considerations. 137 Therefore, this position should be reflected in the final regulations relating to the issuance of Government-Backed Securities in bearer form.

134. This latter alternative was used with respect to Eurobonds issued after July 18, 1984, so that any debt assumption by the savings and loan association would not be affected by the effective date provisions of section 127 of the 1984 Act. Furthermore, any interest paid thereafter to Foreign Persons by the savings and loan association would be exempt from U.S. withholding tax. See supra notes 1, 50.

135. See, e.g., Letter from Christopher Branda, Jr., Esq., on behalf of Florida Federal Savings and Loan Association, to Mr. Stephen E. Shay, Deputy International Tax Counsel, Treasury Department (September 21, 1984); Grant Letter, supra note 133.

136. I.R.C. § 1001 and the Treasury Regulations thereunder set forth the general rule for gain or loss recognition purposes that an exchange of two properties constitutes a taxable event only when the properties differ materially either in kind or extent. See Treas. Reg. § 1.1001-1(a) (1957). The IRS has considered in various factual contexts the question of whether modifications of the terms of an outstanding debt obligation constitute the surrender of that obligation or a new obligation for federal income tax purposes. See generally, Rev. Rul. 73-160, 1973-1 C.B. 365; Rev. Rul. 81-169, 1981-1 C.B. 429; Rev. Rul. 82-188, 1982-2 C.B. 90. In Rev. Rul. 82-122, 1982-1 C.B. 80, the IRS indicated that the mere substitution of a new obligor on an outstanding debt obligation without a substantial change in the rights of the holder of the obligation does not result in a taxable event to the transferor. Rev. Rul. 82-188. This Revenue Ruling is supported by Rev. Rul. 79-155, 1979-1 C.B. 153 and Cunningham v. Comm’r, 44 T.C. 103 (1965), acq., 1966-2 C.B. 4, which support Rev. Rul. 82-122. Based on this authority, it appears reasonable to conclude that a savings and loan association’s assumption of the Eurobond obligations of its Antilles Finance Subsidiary should not constitute the issuance of a new obligation by the association for purposes of the September 7, 1984 effective date because no substantial change will occur in the obligations of the association (i.e., to repay an amount equal to the face amount of the Eurobonds) or in the rights of the holders of the Eurobonds.

137. It is reasonable to conclude that the Treasury Department’s September 7, 1984 announcement was not intended to affect transactions which parties had committed to prior to this date. This conclusion is evidenced by the Treasury Department’s announcement on September 14, 1984 that certain issues of U.S. Government-Backed Securities in bearer form that were
b. Safe Harbor for Certain Bearer Debt Obligations

The repeal of the U.S. withholding tax on interest applies only to debt obligations issued after July 18, 1984. Therefore, interest payable on debt obligations issued by a finance subsidiary of a U.S. corporation on or before July 18, 1984 will not constitute Portfolio Interest even if the obligations are subsequently assumed by the U.S. parent corporation.

On audit of a number of U.S. corporations the IRS has recently challenged the exemption from the withholding tax of interest paid to Foreign Persons by Antilles Finance Subsidiaries of these corporations. Section 127(g)(3) of the 1984 Act provides a special "safe harbor" rule for the purpose of resolving the issue relating to IRS audits of foreign finance subsidiaries of U.S. corporations in existence on June 22, 1984. If the requirements of this "safe harbor" rule are met, the debt obligations issued by such a foreign finance subsidiary will be treated for federal income tax purposes as obligations of the finance subsidiary, rather than of its U.S. parent-guarantor, and interest paid by the finance subsidiary to Foreign Persons with respect to these obligations will be exempt from U.S. withholding tax. These requirements stipulate that:

138. 1984 Act, supra note 1, § 127(g). See also supra note 70.
139. 1984 Act, supra note 1, § 127(g)(3). See supra notes 38–39 and accompanying text.
140. Congress also intended that the interest paid to the foreign finance subsidiary by its affiliate be treated for all federal income tax purposes as paid to a resident of the foreign country in which the foreign finance subsidiary is incorporated, so that this interest typically would not be subject to U.S. withholding tax. See GENERAL EXPLANATION OF THE 1984 ACT, supra note 23, at 397.

It should be noted that after the enactment of the 1984 Act, the IRS issued Revenue Ruling 84-152, 1984-2 C.B. 181 and Revenue Ruling 84-153, 1984-2 C.B. 183. At the time of their issuance these rulings had the effect of subjecting to U.S. withholding tax interest payments made on debt obligations issued between June 22 and July 18, 1984 by Antilles Finance Subsidiaries. Revenue Ruling 84-153 further rules that interest paid on obligations issued by an Antilles Finance Subsidiary after July 18, 1984 will also be subject to U.S. withholding tax if the issuance does not satisfy the requirements of the Eurobond Registration Exemption.

On October 18, 1984, the IRS announced that it was prepared to provide relief from the holding of Revenue Ruling 84-153 to issuers of, or investors in, obligations "in process prior to June 22, 1984" who believe they have a reasonable basis for claiming such relief under established IRS procedures. The IRS announced that requests for relief would be acted upon promptly in an effort to avoid forcing the finance subsidiaries to either immediately call the obligations or provide a "gross up" for any withholding tax imposed, actions typically required in Eurobond obligations. TREAS. NEWS, Oct. 18, 1984. The IRS provided for such relief in
(1) the foreign finance subsidiary was in existence on or before June 22, 1984;
(2) the principal purpose of this finance subsidiary on the date of its interest payments was issuing its debt obligations, holding short-term obligations and lending proceeds of these obligations to its U.S. affiliates (i.e., a related person as specifically defined);
(3) the interest payments are made to the finance subsidiary by a U.S. affiliate with respect to an obligation issued before June 22, 1984; and
(4) on the date of the interest payment the foreign finance subsidiary satisfied the conditions imposed in the published rulings issued by the IRS prior to 1974 with respect to finance subsidiaries.

The IRS recently ruled that several U.S. corporations are entitled to utilize this “safe harbor” rule prescribed by section 127(g)(3) of the 1984 Act.\textsuperscript{143}

Private Letter Ruling 852055 (February 19, 1985), as clarified by Private Letter Ruling 8525031 (March 22, 1985). On September 30, 1985 the IRS announced that the holdings in Revenue Rulings 84-152 and 84-153 will not be applied to (1) interest payments made with respect to debt obligations issued prior to October 15, 1984 (the date these rulings were issued by the IRS), and (2) interest payments made with respect to debt obligations issued on or after October 15, 1984 pursuant to a binding written agreement entered into prior to that date, including debt obligations issued upon the exercise of a warrant or upon the conversion of a convertible obligation, if such warrant or convertible obligation was issued prior to October 15, 1984. See \textit{Internal Revenue Service News Release, IR-85-98} (Sept. 30, 1985). This relief is contained in Rev. Rul. 85-163, 1985-41 I.R.B. 25.

Various members of the Ways and Means Committee of the House of Representatives have formally requested the Treasury Department to reconsider its position in Revenue Rulings 84-152 and 84-153 in view of the significant adverse economic impact of these rulings on the Netherlands Antilles. These Congressmen assert that in enacting section 127 of the Act, Congress did not intend to jeopardize the exemption from U.S. withholding tax previously thought to exist with respect to interest payable in connection with Eurobond offerings made through Antilles Finance Subsidiaries of U.S. corporations. See, e.g., Letter from Rep. William M. Thomas (R-Cal.) to Ronald A. Pearlman, Assistant Secretary, (Tax Policy), Treasury Department (May 23, 1985); Letter from Rep. Frank J. Guarini (D.-N.J.) to Mr. Ronald A. Pearlman, Assistant Secretary (Tax Policy), Treasury Department (May 23, 1985).

141. According to the Joint Committee on Taxation, Congress intended that U.S. affiliate obligations issued prior to June 22, 1984 include rollovers (regardless of whether a change in the interest rate occurs) of pre-June 22, 1984 affiliate obligations and new affiliate obligations which are substituted for those obligations, provided that (1) the total amount of U.S. affiliate obligations is not thereby increased, and (2) the foreign finance subsidiary does not acquire new funds after June 22, 1984. For example, a foreign finance subsidiary cannot take advantage of this rollover rule if it issues new debt to raise new capital after June 22, 1984. Congress did not, however, intend that this finance subsidiary should lose the benefit of this rollover rule by making a contribution to capital intended to increase its debt-equity ratio made necessary by the accrual of original issue discount after June 22, 1984, on an obligation outstanding on June 22, 1984. See \textit{General Explanation of the 1984 Act, supra} note 23, at 397–98. A recent letter to the Treasury Department has suggested that certain technical corrections should be made to section 127(g)(3) of the 1984 Act, in order to ensure that its “safe harbor” rule will unequivocally apply to those factual situations which the rule was intended to cover. See Letter from Lawrence F. O’Brien, III, to Mikel Rollyson, Tax Legislative Counsel, Treasury Department, (May 7, 1985).


143. See, e.g., Technical Advice Memorandum 8530002 (April 16, 1985).
In addition, according to the Joint Committee on Taxation, Congress did not intend that (1) any inference should be drawn from this special "safe harbor" relief provision for foreign finance subsidiaries as to the proper resolution of other federal income tax issues regarding these subsidiaries, and (2) this relief provision would serve as a precedent for the federal tax treatment of other transactions involving Tax Treaties or U.S. tax law.\textsuperscript{144} The 1984 Act, however, does not provide a similar "safe harbor" rule for debt obligations issued in the Eurobond market by an 80/20 Corporation or by a foreign finance subsidiary controlled by Foreign Persons.

Bills originally introduced into Congress to make certain technical corrections to the 1984 Act and to other recently enacted tax legislation would liberalize the "safe harbor" rule discussed above in two respects.\textsuperscript{145} First, these bills would extend the applicability of the "safe harbor" rule to interest paid to a foreign finance subsidiary (i.e., an Antilles Finance Subsidiary) by an affiliated foreign corporation with respect to debt obligations issued before June 22, 1984, if at least 50 percent of the foreign payor's gross income for the three-year period ending on or before March 31, 1984 and the close of its taxable year preceding the payment of the interest in question constituted Effectively Connected Income to the payor. Second, these bills would also extend the applicability of the "safe harbor" rule to interest paid by an affiliated U.S. corporation to a foreign finance subsidiary where the finance subsidiary is controlled by foreign persons and does not constitute a Controlled Foreign Corporation.\textsuperscript{146}

c. Satisfaction of the Eurobond Registration Exemption

The Temporary Regulations also provide detailed rules for determining whether interest payable on a particular debt obligation issued in bearer form qualifies as Portfolio Interest because the obligation satisfies the Eurobond Registration Exemption.\textsuperscript{147} These rules are applicable on an obligation-by-
obligation basis.\textsuperscript{148} The Temporary Regulations also provide special rules for the satisfaction of the Eurobond Registration Exemption by foreign branches of U.S. financial institutions, foreign corporations and foreign governments.\textsuperscript{149}

In drafting the Temporary Regulations the Treasury Department sought to achieve a balance between the need to protect against tax evasion by U.S. Persons with respect to the reporting of interest income and the objective of the 1984 Act of facilitating U.S. borrowers' access to international capital markets.\textsuperscript{150} This section outlines the specific rules contained in the Temporary Regulations with respect to satisfaction of each of the three Eurobond Registration Exemption Requirements.\textsuperscript{151}

The first requirement is that bearer obligations be issued under arrangements reasonably designed to ensure that the obligation will be sold only to Foreign Persons.\textsuperscript{152} The Temporary Regulations provide that an obligation will be considered to be issued under arrangements reasonably designed to ensure sales only to Foreign Persons if, in connection with its original issuance, the obligation is offered for sale or resale and delivered only outside of the United States and its possessions and either one of the following two tests are met:

(1) if, prior to the issuance of the obligation, the issuer makes a good faith determination in reliance upon the written opinion of counsel that the obligation need not be registered under the Securities Act of 1933 because it is intended for distribution to persons who are not "U.S. Persons" (as such term is defined for purposes of the Securities Act of 1933);\textsuperscript{153} or

(2) if the obligation is either registered under the Securities Act of 1933, is exempt from registration pursuant to sections 3 or 4 of such Act (i.e., exempt from registration for a reason other than intended distribution to non-"U.S. Persons"), or does not qualify as a "security" under such Act and \textit{all} of the following conditions are met:\textsuperscript{154}

(i) The issuer does not, and each underwriter and each member of the selling group, if any, covenants that it will not, in connection with the original issuance of the obligation, offer to sell or resell the obligation in


\textsuperscript{150} T.D. 7965, 1984-38 I.R.B. 6. See also Treas. DEP'T NEWS, supra note 128.

\textsuperscript{151} See supra note 63 and accompanying text.

\textsuperscript{152} Id.


WITHHOLDING TAX REPEAL

Bearer form to a U.S. Person unless the person is a U.S. financial institution\(^\text{155}\) that provides a written statement that it will comply with certain specified Code provisions and related Treasury Department regulations governing the sanctions on United States holders of bearer obligations (hereinafter a Qualified U.S. Financial Institution);\(^\text{156}\)

(ii) In connection with a sale or resale during the original issuance of the obligation, each underwriter and each member of the selling group, if any, or the issuer if there is no underwriting or selling group, sends to each purchaser of the obligation a confirmation stating that the purchaser's acceptance of delivery of the obligation constitutes a representation and warranty either that it is not a U.S. Person or that it is a Qualified U.S. Financial Institution and, if the purchaser is a dealer, that the dealer will send similar confirmations to its purchasers;\(^\text{157}\)

(iii) In connection with its original issuance, the definitive form of the obligation will be delivered to the purchaser entitled thereto only if the purchaser has presented the issuer, an agent for the issuer, an underwriter, or a member of the selling group, if any, with a certificate stating that the obligation is not being acquired by or on behalf of a U.S. Person, or for offer to resell or for resale to a U.S. Person, or, if a beneficial interest in the obligation is being acquired by a U.S. Person, that such person is a Qualified U.S. Financial Institution or is acquiring the obligation through a Qualified U.S. Financial Institution and the obligation is held by a Qualified U.S. Financial Institution;\(^\text{158}\) and

(iv) the issuer, underwriter or member of the selling group does not have actual knowledge that the certificate described in (iii) above is false. For this purpose, a person shall be deemed to have actual knowledge that the beneficial owner of the obligation (other than a Qualified U.S. Financial Institution) is a U.S. Person if its records reflect a U.S. address for the beneficial owner and it does not possess any clear and convincing documentary evidence that the beneficial owner is not a U.S. Person.\(^\text{159}\)

Conditions (iii) and (iv) of the second alternative test require in certain cases that the underwriter of the obligation or a member of the selling group send a confirmation to the purchaser of the obligation involved or receive a certificate from this purchaser. The Temporary Regulations do not, however, discuss the effect of a failure of the underwriter or selling group member to satisfy these conditions. Comments submitted to the Treasury Department on this issue assert that the issuer of the obligation should not be subject to

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155. A "financial institution" for this purpose generally means an underwriter, broker, dealer, bank, insurance company, pension fund, investment advisor, regulated investment company, or finance company that either: (1) holds the bearer obligation outside the United States in connection with a business which it conducts outside of the United States; or (2) holds the bearer obligation inside or outside the United States for its own account and discloses in its U.S. federal income tax returns information with respect to the income, gain or loss from the obligation. See I.R.C. § 165(j)(3) (1982); Temp. Treas. Reg. § 1.165-12T(c)(1)(iv) (1984).


158. Temp. Treas. Reg. § 1.163-5T(c)(2)(B)(i)(4) (1984). This certificate may be submitted by a securities clearing organization (such as Euroclear or CEDEL) that holds members' securities in the ordinary course of its business and transfers obligations among the members by credit or debit to members' accounts, provided that the certificate is based on statements provided to the organization by its members.

any of the tax sanctions imposed with respect to noncompliance with the Registration Requirements if the noncompliance with these conditions results from a failure of the underwriter or selling group member to satisfy its duties.160 This position appears justified, since such a failure would usually be beyond the control of the issuer, and the threatened imposition of tax sanctions on the issuer would therefore not serve to further the purposes for which these sanctions were intended.

In addition to the availability of the two alternative tests discussed above, the issuance of an obligation outside of the United States by a foreign government or a foreign branch of a U.S. bank will be considered to satisfy the first Eurobond Registration Exemption Requirement6 if the issuer does not “significantly engage in interstate commerce” with respect to the issuance (either directly or through its agent, an underwriter, or a member of the selling group).162 The Temporary Regulations define “interstate commerce” as trade or commerce in debt obligations or any transportation or communication relating thereto between any foreign country and the United States or its possessions.163

The Temporary Regulations also provide detailed rules for determining whether an issuer is to be treated as engaged in “interstate commerce” for this purpose. For example, an issuer will not be considered to “engage significantly in interstate commerce” with respect to the issuance of an obligation if the only activities with respect to which the issuer uses the means or instrumentalities of interstate commerce are “activities of a preparatory or auxiliary nature” that do not involve communication between a prospective purchaser and an issuer, its agent, an underwriter, or a member of the selling group inside the United States or its possessions.164 This “interstate commerce” test will apply to obligations issued by foreign branches of U.S. commercial banks and foreign bank subsidiaries of U.S. Persons only if

1. the obligation is issued outside of the United States by a foreign branch through which the issuer is engaged in the active conduct of a banking business outside of the United States and in connection with that foreign banking business,165

2. the obligation is sold directly to the public and is not issued as part of a larger issuance made by means of a public offering,166 and

160. See, e.g., Letter from John Fletcher Rolph, III, Vice President - Tax Legislation, Citibank N.A., to Commissioner of Internal Revenue Service (November 5, 1984) [hereinafter cited as Rolph Letter].
161. See supra note 63 and accompanying text.
164. Id. Examples of “activities of a preparatory or auxiliary nature” that may use the instrumentalities of interstate commerce are negotiation between the issuer and the underwriter regarding the terms and pricing of an issue, the transfer of funds to the issuer’s office, consultation with lawyers, accountants or other financial advisors, document drafting and printing and provision of payment or delivery instructions to members of the selling group by an issuer’s office or agent in the United States. Temp. Treas. Reg. § 1.163-5T(c)(2)(iii), Ex. 1 (1984).
(3) the issuer maintains documentary evidence that the purchaser is either not a U.S. Person or constitutes a Qualified U.S. Financial Institution.\textsuperscript{167}

Finally, the Temporary Regulations provide that this "interstate commerce" test does not apply to an obligation which

(1) is guaranteed by a U.S. shareholder owning at least 10 percent of the stock of the issuer (hereinafter a U.S. Shareholder),\textsuperscript{168}

(2) is convertible into debt or equity interest in a U.S. Shareholder of the issuer,\textsuperscript{169} or

(3) is "substantially identical" to an obligation issued by a U.S. Shareholder of the issuer (i.e., the face amount, interest rate, term of the issue, due date for payment and maturity date of each obligation is substantially identical to the other obligation).\textsuperscript{170}

The scope of the "substantially identical" exception is not entirely clear. This exception could be read as applying only where all of the listed factors are "substantially identical". To avoid creating unnecessary complexity in the case of an issuer with many debt issues outstanding, a significant variation in one of these factors arguably should be sufficient to make this exception inapplicable. Comments filed on the Temporary Regulations suggest that the final Treasury Regulations provide a "safe harbor" rule on the extent of the variation required in these factors to preclude the application of this third exception.\textsuperscript{171}

Reversing a prior regulatory rule,\textsuperscript{172} the Temporary Regulations also provide that an obligation issued after September 21, 1984 will not satisfy the first Eurobond Registration Exemption Requirement\textsuperscript{173} (thereby causing the interest payable on the obligation to fail to qualify as Portfolio Interest) if the obligation was initially issued in registered form and is convertible under any

\textsuperscript{170} Temp. Treas. Reg. § 1.163-5T(c)(2)(ii)(C) (1984). This latter requirement would prohibit any foreign finance subsidiary of a corporation from issuing Eurobond obligations at the same time that the U.S. parent corporation issues a "substantially identical" obligation "in registered form" in the United States.

The preamble to the Temporary Regulations indicates that the Treasury Department felt it necessary to include the "substantially identical" exception because a "matching" of the terms of the obligations of a U.S. Shareholder with the terms of the obligations of a foreign issuer could be treated as an "indirect guarantee". There does not appear to be any support for this statement in either the legislative history of section 127 of the 1984 Act or the express statutory terms thereof.

\textsuperscript{171} See, e.g., Rolph Letter, supra note 160.
\textsuperscript{172} In 1982 and 1983, the Treasury Department issued temporary and proposed regulations which provided that an obligation issued in registered form could be converted into bearer form if: (1) the issuance of the obligation was part of a large debt offering; (2) the obligation was sold in bearer form in accordance with the Eurobond Registration Exemption Requirements; and (3) the issuer or its agent received a certificate upon conversion stating that the person entitled to delivery of the obligation is a Foreign Person or a Qualified U.S. Financial Institution. 47 Fed. Reg. 51,361 (1982); 48 Fed. Reg. 39,953 (1983). See, e.g., Prop. Treas. Reg. § 1.163-5T(c)(2)(vi) (1983).

\textsuperscript{173} See supra note 63 and accompanying text.
circumstances into a bearer obligation. 174 While a bearer debt obligation issued in accordance with the procedures outlined above 175 may subsequently be converted into registered form for later resale in the U.S. market, this obligation cannot be later reconverted back into bearer form. 176 The preamble to the Temporary Regulations indicates that this "one-way" convertibility rule is premised on the Treasury Department's concern that convertibility of a registered obligation into a bearer obligation could create tax compliance problems by substantially increasing the volume of bearer obligations available for purchase by U.S. Persons. 177

The position taken by the Temporary Regulations appears supportable from a technical standpoint. As stated above, the Code exempts from U.S. withholding tax only interest which is paid on obligations "described in 163(f)(2)(B)". One of the requirements of I.R.C. § 163(f)(2)(B) is that "arrangements" exist which are reasonably designed to ensure that a particular debt obligation is sold (or resold in connection with its original issuance) only to a Foreign Person. The Treasury Department has expressed the view that conversion of a registered debt obligation into bearer form does not satisfy this statutory requirement since (1) conversion does not result in the issuance of a new obligation, and (2) a registered debt obligation originally sold to a U.S. Person does not satisfy this requirement. At least one commentator on the Temporary Regulations has argued that both the express language of section 127 of the 1984 Act and its legislative history support this position. 178

Other commentators, however, generally criticize the Treasury Department's position that the convertibility of a registered debt obligation into a bearer obligation prevents the obligation from satisfying the Eurobond Registration Exemption Requirements. The primary criticism concerns the adverse impact which this position would have on the creation of a more efficient worldwide market for debt securities and the expansion of the number of transactions in the Eurobond secondary market. 179 Such efficiency should result from increasing the number of U.S. corporations having both access to the Euromarket and the ability to raise funds at reduced financing costs, an important goal of Congress when it repealed the U.S. withholding tax on interest. This efficiency should also benefit the secondary Eurobond market by increasing the liquidity of the debt portfolio of participants in this market.

175. See supra notes 152–160 and accompanying text.
178. See Letter from James P. Fuller to Mr. Steven R. Lainoff, International Tax Counsel, Department of the Treasury (March 11, 1985).
179. See, e.g., Saunders Letter, supra note 107; Letter from John H. Gutfreund, Chairman of Salomon Brothers, Inc., to Donald T. Regan, Secretary of the Treasury (December 5, 1984) [hereinafter cited as Gutfreund Letter]; Rolph Letter, supra note 160.
Because of the inability of holders of registered debt obligations to convert these obligations into bearer form, the Euromarket arguably will continue to provide financing only to a limited number of U.S. corporate issuers and will thwart the Congressional intent underlying section 127 of the 1984 Act. Further, the “one-way” convertibility rule contained in the Temporary Regulations likely will preserve the existing distinction between the Eurobond and domestic bond markets (with the former market being restricted to bearer debt obligations and the latter market restricted to registered obligations) and will adversely affect the ability of U.S. securities firms to compete with foreign firms.

The criticism of the convertibility position in the Temporary Regulations appears to be supported by sound tax policy reasons. Contrary to the concern regarding tax compliance expressed by the Treasury Department in the preamble to the Temporary Regulations, restriction of the conversion of registered obligations into bearer obligations could possibly increase the number of debt obligations initially issued in bearer form. Commentators on the Temporary Regulations have suggested that minor modifications to the procedural requirements of “two-way” convertibility contained in the proposed Treasury regulations issued in 1983 would adequately address the Treasury Department’s compliance concerns by restricting the circumstances in which U.S. Persons could acquire bearer debt obligations.

The second Eurobond Registration Exemption Requirement states that interest on the obligation must be payable outside the United States and its possessions. The Temporary Regulations provide that interest will be considered payable outside of the United States and its possessions if payment can be made only upon presentation of a coupon, or upon the making of any


181. See Gutfreund Letter, supra note 179. A prohibition on the conversion of registered debt obligations into bearer form arguably will continue the disadvantages that U.S. securities firms have faced in competing with foreign securities firms in the primary and secondary Eurobond markets. Foreign securities firms historically have distributed a large portion of initial Eurobond offerings and this situation likely will not change under the Temporary Regulations. Because U.S. securities firms generally will be unable to sell registered debt obligations to Foreign Persons, foreign securities firms will be able to sell bearer obligations to Qualified U.S. Financial Institutions (i.e., those financial institutions statutorily permitted to hold such obligations without incurring the Code’s “holder sanctions”). Accordingly, foreign securities firms will be able to sell debt obligations in the United States of a type normally traded in their home market, while U.S. firms will not have a similar opportunity. Id.

Because the Registration Requirements generally require long-term debt obligations initially issued in the United States to be issued in registered form, the position in the Temporary Regulations may very well have the effect of preventing such obligations from ever being traded in the Eurobond secondary market (because of the reluctance of Foreign Persons to purchase registered debt obligations). This Treasury Department position will prevent the issuance of “global” bonds which would have appeal to investors in both the United States and Eurobond markets. Id.

182. See, e.g., Rolph Letter, supra note 160.

183. See, e.g., Gutfreund Letter, supra note 179; Letter from Price Waterhouse to Commissioner of Internal Revenue (October 22, 1984).

184. See supra note 63 and accompanying text.
other demand for payment, to the issuer or a paying agent at a location outside of the United States and its possessions.\textsuperscript{185} The fact that the funds paid are credited to an account maintained by the payee outside the United States are not relevant to the satisfaction of this requirement.\textsuperscript{186} An exception permits the issuer or its paying agent to pay interest in the United States if the issuer has appointed paying agents outside the United States with the reasonable expectation that the paying agents will be able to pay the interest in U.S. dollars, but payment outside of the United States becomes illegal or is effectively precluded because of imposition of exchange controls or other similar restrictions on the full payment or receipt of interest in U.S. dollars.\textsuperscript{187}

Interest may be considered paid outside of the United States for purposes of the second Eurobond Registration Exemption Requirement even if payment is made by a draft drawn on a U.S. bank account or by a wire or other electronic transfer from a U.S. account.\textsuperscript{188} Interest paid by a transfer of funds into an account maintained by the payee in the United States or mailed to an address in the United States generally will not be considered to be made outside of the United States if the interest is payable on an obligation issued by a U.S. corporation, a Controlled Foreign Corporation\textsuperscript{189} or a foreign corporation whose interest payments constitute U.S. Source Interest.\textsuperscript{190} However, such interest will be considered to be made outside of the United States if the payment is to a financial institution as a step in the clearance of funds and the interest is promptly credited to an account maintained outside of the United States for the financial institution or for persons for which the financial institution has collected such interest.\textsuperscript{191}

The third Eurobond Registration Exemption Requirement calls for a statement on the obligation that any U.S. Person who holds the obligation will be subject to limitations under U.S. income tax laws.\textsuperscript{192} To satisfy this requirement, the Temporary Regulations provide generally that the following statement must appear in English on the face of any bearer obligation issued abroad and on any detachable interest coupons of such an obligation:

\textsuperscript{185} Temp. Treas. Reg. § 1.163-5T(c)(2)(v) (1984). The Temporary Regulations provide that a lawsuit brought in the United States or its possessions for payment of the obligation is not considered a demand for payment within the United States for this purpose. \textit{Id.}

\textsuperscript{186} \textit{Id.}

\textsuperscript{187} \textit{Id.}


\textsuperscript{189} \textit{See supra} notes 82–83 and accompanying text.


\textsuperscript{192} \textit{See supra} note 63 and accompanying text.
WITHHOLDING TAX REPEAL

"Any U.S. person who holds this obligation will be subject to the limitations of the U.S. income tax laws, including the limitations provided in section 165(j) and 1287(a) of the Internal Revenue Code".\(^{193}\)

This statement is not, however, required to be included on the face of an obligation which is issued only outside the United States and its possessions by an issuer that does not "significantly engage in interstate commerce" within the meaning of the Temporary Regulations.\(^{194}\)

4. Registered Debt Obligations

Portfolio Interest also includes interest paid on an obligation issued "in registered form" if the Withholding Agent has received a written statement containing certain information assuring the Withholding Agent that the "beneficial owner" of the obligation is not a U.S. Person.\(^{195}\) The form of this statement differs depending on whether the issuance of the registered debt obligation satisfies certain conditions so as to be treated as "targeted to foreign markets".\(^{196}\) The Temporary Regulations provide that obligations issued "in registered form" by U.S. corporations and the U.S. Government and sold (or resold in connection with its original issuance) only to Foreign Persons (or to foreign branches of U.S. financial institutions) under procedures similar to those satisfying the Eurobond Registration Exemption will be treated as "targeted to foreign markets" (hereinafter Targeted Registered Obligations). Under the Temporary Regulations, Targeted Registered Obligations are subject to less stringent rules concerning certification of a Foreign Person's status than are registered obligations not constituting Targeted Registered Obligations (hereinafter Non-Targeted Registered Obligations).\(^{197}\)

Targeted Registered Obligations differ in several significant ways from obligations issued under the Eurobond Registration Exemption, however. While a Targeted Registered Obligation must be issued under procedures similar to those satisfying the Eurobond Registration Exemption, the condition in the Eurobond Registration Exemption Requirements requiring that an obligation be offered for sale or resale in connection with its original issuance outside the United States does not apply to registered obligations offered for sale through a public auction.\(^{198}\) Similarly, the condition in the Eurobond Registration Exemption Requirements that an obligation be delivered only


\(^{194}\) Id. See supra notes 162–171 and accompanying text.

\(^{195}\) I.R.C. §§ 871(h)(2)(B), 881(c)(2)(B).


outside the United States does not apply to registered obligations sold through public auction where the obligations are considered issued "in registered form" by virtue of the fact that they may be transferred only through a "book entry system". These exceptions to the Eurobond Registration Exemption Requirements clearly were intended to apply to the issuance of Targeted Registered Obligations by the U.S. Government.

a. Non-Targeted Registered Obligations

Interest paid on Non-Targeted Registered Obligations may qualify as Portfolio Interest (and thereby be exempt from U.S. withholding tax) only if the "beneficial owner" of the obligation is identified in a statement (signed under penalties of perjury) by either the beneficial owner or a securities clearing organization, a bank, or another financial institution that holds customers' securities in the ordinary course of its trade or business (hereinafter a Financial Institution). A statement from the beneficial owner of the Non-Targeted Registered Obligation must:

1. certify that the owner is not a U.S. Person; and
2. provide the name and address of the beneficial owner on a Form W-8 (Certificate of Foreign Status) or on a substitute form that is substantially similar to a Form W-8. If there is any change in the information provided on this statement, the beneficial owner must so inform the person otherwise required to withhold U.S. tax within 30 days of the change. Legislation proposing to make technical corrections to the 1984 Act and certain other recently enacted tax legislation would make it clear that the beneficial owner of a Non-Targeted Registered Obligation the interest on which is otherwise eligible for the withholding tax repeal may claim a refund of any U.S. tax withheld where this statement is provided only after one or more interest payments have already been made.

Section 127 of the 1984 Act provides the Secretary of the Treasury with discretion to determine in appropriate cases that a statement provided by the beneficial owner of a Non-Targeted Registered Obligation does not satisfy the requirements of this provision. In such a case, all payments of interest that otherwise qualify as Portfolio Interest to that person would become subject to U.S. withholding tax.

Neither the Code nor the Treasury Regulations defines the term "beneficial owner" for purposes of determining the identity of the Foreign Person

199. Id.
201. This statement must be prepared, renewed and retained in accordance with the procedures generally applicable to the information reporting required with respect to interest paid to Foreign Persons. See Treas. Reg. § 1.6049-5(b)(2)(iv) (1984).
required to file the statutorily prescribed written statement. This definition should generally not create any interpretative problems where the legal owner of a Non-Targeted Registered Obligation is a nonresident alien individual or a foreign corporation. However, the definition of the term “beneficial owner” is crucial in determining compliance with the statutory requirement where a Non-Targeted Registered Obligation is registered in the name of a partnership, trust or estate. The issue arises in this situation whether the “beneficial owner” of the obligation is the partnership, trust or estate or the partners or beneficiaries thereof, as the case may be.

Under the literal language of the Temporary Regulations, it appears that the “beneficial owner” of a Non-Targeted Registered Obligation held by a partnership, trust or estate is the entity itself. However, under existing withholding tax rules, a strong argument can be made that the resolution of this issue depends on whether the partnership, trust or estate is classified as a “domestic” or a “foreign” entity for federal income tax purposes. Thus, interest paid by a U.S. Person to a domestic partnership, trust or estate is not

204. This conclusion is supported by the Treasury Department Regulations concerning the information reports to be filed annually by payors of interest to U.S. Persons and Foreign Persons. See Temp. Treas. Reg. § 35a.9999-5(b), Q&A-9 (1984); Treas. Reg. § 1.6049-5(b)(2)(iv) (1984). The Temporary Regulations require that Form W-8 be prepared, renewed and retained in accordance with the procedures generally applicable to the information reporting required with respect to interest paid to Foreign Persons. See supra note 201. In the case of interest paid to a partnership, trust or estate, these procedures provide that the Form W-8 is to be filed by the general partner on behalf of a partnership and by a “fiduciary” on behalf of a trust or estate. I.R.C. § 7701(a)(6) defines a “fiduciary” as including a trustee, executor or administrator.

The conclusion set forth in the text is also supported by the recently proposed Treasury Department regulations concerning the withholding of tax on income paid to a Foreign Person entitled to the benefits of a Tax Treaty. These regulations require the “beneficial owner” of the income to provide a Withholding Agent with a Certificate of Residence containing certain identifying information regarding the beneficial owner. These regulations assume that a foreign partnership, trust or estate may be the “beneficial owner” of income for purposes of providing the requisite certificate. See Prop. Treas. Reg. §§ 1.1441-6(e)(1), and -6(e)(3)(ii) (1984). See also Letter from Tony M. Edwards to Hon. Roscoe L. Egger, Jr., Commissioner of Internal Revenue (March 25, 1985).

205. A “domestic” partnership means a partnership created or organized in the United States or under the law of the United States or any other state. I.R.C. § 7701(a)(4).

A trust generally is treated as a “domestic” trust if it constitutes a resident alien. I.R.C. § 7701(a)(30). No single factor or group of factors is conclusive in determining the nonresident alien status of a trust and all relevant factors must be considered. These factors generally include the country under whose laws the trust was created, the location of the assets of the trust, the nationality and residence of the trustee, the nationality of the grantor and the nationality of the beneficiaries. See S. REP. NO. 938, 94TH CONG., 2D SESS. 215, REPRINTED IN 1976 U.S. CODE CONG. & AD. NEWS 3439, 3645; H.R. REP. NO. 658, 94TH CONG., 1ST SESS. 206, REPRINTED IN 1976 U.S. CODE CONG. & AD. NEWS; JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 94TH CONG., 2D SESS. 218 (COMM. PRINT 1976). The leading cases in determining the status of a trust as a nonresident alien are Maximov v. United States, 373 U.S. 49 (1963), aff'd 299 F.2d 565 (2d Cir. 1962); B.W. Jones Trust v. Comm'r, 46 B.T.A. 531 (1942), aff'd, 132 F.2d 914 (4th Cir. 1943). Both of these cases found that the trusts involved did not constitute “foreign trusts” where the trusts were each administered in the United States and had at least one trustee. Other factors also supported this conclusion in each of the cases. For examples of the position of the Internal Revenue Service regarding the nonresident alien status of a trust, see Rev. Rul. 60-181, 1960-1 C.B. 257, MODIFYING T.I. 1885, C.B. II-2, 164 (1923); Rev. Rul. 70-242, 1970-2 C.B. 89; Rev. Rul. 73-521, 1973-2 C.B. 209.
subject to U.S. withholding tax. However, distributions of this interest by the
domestic partnership, trust or estate to its partners or beneficiaries, as the
case may be, who are Foreign Persons are subject to such withholding tax,
and the distributing entity is the Withholding Agent.\(^{206}\) Since the Temporary
Regulations require that a Form W-8 be furnished to the Withholding Agent,
it appears that Forms W-8 should be furnished to the domestic partnership,
trust or estate by those partners or beneficiaries who are Foreign Persons and
eligible for the benefits of section 127 of the Act.

A different result, however, appears warranted in the case of interest
paid by a U.S. Person to a foreign partnership, trust or estate which is then
distributed by the entity to its partners or beneficiaries who are Foreign Per-
sons. In this situation, U.S. tax generally would be withholdable when the
U.S. Person pays the interest to the foreign entity, and the U.S. Person would
be the Withholding Agent.\(^{207}\) Therefore, the foreign entity arguably should
be treated as the “beneficial owner” of the Non-Targeted Registered Obliga-
tion in this situation and should therefore be the party providing a Form W-8
to the Withholding Agent.\(^{208}\)

In addition to the certification required on Form W-8, the Temporary
Regulations require that the beneficial owner of a Non-Targeted Registered
Obligation provide the Withholding Agent with an ownership certificate on
Form 1001 (Ownership, Exemption, or Reduced Rate Certificate),\(^{209}\) which
contains information similar to that required by Form W-8.

A statement furnished by a Financial Institution which holds a Non-
Targeted Registered Obligation as a Middleman must be signed by an author-
ized representative of the Financial Institution and must state that:

(1) the Financial Institution has received from the beneficial owner of the
obligation a Form W-8 or a substitute form, or
(2) it has received from another Financial Institution a similar statement that
it, or another Financial Institution acting on behalf of the beneficial owner, has
received the Form W-8 (or a substitute form) from the beneficial owner and the
person otherwise required to withhold.\(^{210}\)

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207. Id. However, no tax need be withheld upon any item of income paid to a foreign
partnership engaged in trade or business within the United States at any time during the taxable
year involved if it is established to the satisfaction of the Director of International Operations of
the IRS that the imposition of such withholding would impose an undue administrative burden
for that year and that collection of the applicable withholding tax on the distribution made by the
foreign partnership to its partners who are Foreign Persons would not be jeopardized by this
208. If the foreign partnership, trust or estate is treated as the “beneficial owner” of the
Non-Targeted Registered Obligation for purposes of the Temporary Regulations, it is not clear
whether the foreign entity must itself obtain Forms W-8 from those of its partners or benefici-
ciaries who are Foreign Persons.
210. Id. While no particular form is required for this statement, the statement must provide
the name and address of the beneficial owner and must be accompanied by a copy of the Form
W-8 provided by the beneficial owner.
In the case of multiple Financial Institutions between the beneficial owner of the Non-Targeted Registered Obligation and the person otherwise required to withhold, this statement must be given by each Financial Institution to the one immediately preceding it in the chain.\textsuperscript{211} Thus, the person required to withhold U.S. tax if the requisite statement is not received generally is the last Financial Institution in the chain of payment that is within the United States. If the information on the Form W-8 changes, the beneficial owner must so notify the Financial Institution acting on its behalf within 30 days of such change and the Financial Institution must promptly so inform the U.S. Person otherwise required to withhold.\textsuperscript{212} This notice must also be given if the Financial Institution has actual knowledge that the information has changed but has not been so informed by the beneficial owner.\textsuperscript{213}

A Withholding Agent otherwise required to deduct and withhold U.S. tax upon a payment of interest on a Non-Targeted Registered Obligation and who receives the certificate described above must make an information return on Form 1042S, U.S. Annual Information Statement of Income Paid to Non-resident Aliens, etc., with respect to the payment and attach the statement to this form.\textsuperscript{214} If this statement is not received, the Withholding Agent must deduct and withhold the appropriate tax unless certain conditions exist.\textsuperscript{215}

In certain respects, the certification requirements applicable to Non-Targeted Registered Obligations appear inconsistent with the express provisions and legislative intent of section 127 of the 1984 Act and the underlying policy thereof. This provision requires that the Withholding Agent receive a "statement . . . that the beneficial owner of the Non-Targeted Registered Obligations is not a U.S. Person" and that this statement may be received directly from the beneficial owner or from Financial Institutions acting on behalf of the beneficial owner. Nothing in section 127 of the 1984 Act requires that the identity of the Foreign Person holding a Non-Targeted Registered Obligation be disclosed to the Withholding Agent. Moreover, the legislative history of the 1984 Act indicates that Congress clearly did not intend to require Foreign Persons to compromise their anonymity in order to acquire registered debt obligations issued by U.S. borrowers.\textsuperscript{216} Finally, the

\textsuperscript{211} Id.
\textsuperscript{212} Id.
\textsuperscript{213} Id.
\textsuperscript{215} The Withholding Agent is not required to withhold tax if:
(1) the interest is paid to, or collected on behalf of, an Exempt Recipient which is a U.S. Person at an address within the United States, or
(2) the interest is paid to a person at an address within the United States and is subject to backup withholding (e.g., because neither a Form W-8 nor a Form W-9 [Payer's Request for Taxpayer Identification and Certification] has been received).


\textsuperscript{216} The Senate Report relating to the initial Senate proposal to phase out the U.S. withholding tax on interest provided that:
[1]Interest is eligible for the phase-out of tax where paid on an obligation in registered form, provided the U.S. payor (or U.S. person whose duty it would otherwise
Temporary Regulations' burdensome requirements relating to certification of Non-Targeted Registered Obligations and the lack of anonymity which these requirements impose on Foreign Persons likely will result in discouraging the acquisition of registered debt obligations by Foreign Persons and increasing the number of debt obligations issued in bearer form — a result which is clearly inconsistent with Congress' concern for increased tax compliance by U.S. Persons.\textsuperscript{217}

Aspects of the certification requirements have been criticized by securities industry representatives as unnecessarily burdensome. These representatives criticize particularly the requirements that a Foreign Person file a Form 1001 with the Withholding Agent in addition to a Form W-8 and that the certifications be renewed every three years without regard to a change in circumstances. These representatives suggest elimination of the requirement to file a Form 1001 and a requirement that new certifications be provided to the Withholding Agent only when a change in circumstances in fact occurs. The expressed concern is that the imposition of complex and detailed certification requirements will result in substantial administrative inconvenience and expense to Financial Institutions and discourage these institutions from holding Non-Targeted Registered Obligations as nominees for their foreign clients. Such a result appears to contravene the Congressional intent of encouraging the sale of Non-Targeted Registered Obligations to Foreign Purchasers by enabling Financial Institutions to act on behalf of their customers.\textsuperscript{218}

\textbf{b. Targeted Registered Obligations}

Interest on Targeted Registered Obligations\textsuperscript{219} does not always require certification by the beneficial owner of the obligation to avoid the imposition of U.S. withholding tax. As discussed below,\textsuperscript{220} however, the Withholding
Agent is required to withhold U.S. tax unless it receives some form of written confirmation concerning the residence status of the beneficial owner of a Targeted Registered Obligation. The amendments made to the Temporary Regulations in August 1985 change the forms of such written confirmation for interest payments on a Targeted Registered Obligation made: (1) generally after January 15, 1985 with respect to payments to a Financial Institution or to a member of a clearing organization which member is the beneficial owner of the obligation, and (2) after September 19, 1985 with respect to payments to a beneficial owner other than an entity described in clause (1).\textsuperscript{221} The types of written confirmation required for interest payments made before these dates are governed by the rules contained in the August 1984 version of the Temporary Regulations.

Pursuant to the rules contained in the August 1984 version of the Temporary Regulations, receipt of a Form W-8 from the beneficial owner of the obligation is not necessary to avoid U.S. withholding tax if all of the following conditions are met:

(1) the registered owner of the Targeted Registered Obligation is a Financial Institution and the interest is paid to the Financial Institution at an address outside the United States; and
(2) the Withholding Agent (including a foreign paying agent of an issuer that is a U.S. Person) (i) does not have actual knowledge that the beneficial owner of the Targeted Registered Obligation is a U.S. Person, and (ii) receives a certificate from the registered owner or from a member of a clearing organization, which member is the beneficial owner of the obligation, with respect to each interest payment identifying the Targeted Registered Obligation with respect to which it is given and stating that the beneficial owner of the obligation is not a U.S. Person.\textsuperscript{222}

The certification noted in clause (ii) above need not identify the beneficial owner of the Targeted Registered Obligation, and the beneficial owner need not provide sworn statements as to its status as a Foreign Person in order for the Financial Institution to provide this certification.\textsuperscript{223}

As noted above, the August 1985 amendments to the Temporary Regulations provide detailed rules on the types of written confirmations which a Withholding Agent must receive regarding the resident status of the beneficial owner of a Targeted Registered Obligation in order not to withhold U.S.

\textsuperscript{222} Temp. Treas. Reg. § 35a.9999-5(b), Q&A-12, Q&A-14, Q&A-15 (1984). No particular form is required for this certificate. The certificate must be provided by the Financial Institution within 90 days prior to the interest payment. It must be retained in the records of the recipient for at least four years from the end of the calendar year during which it is received. If the certificate is not received within 30 days before the interest payment date, the U.S. payor has discretion to withhold the appropriate amount of U.S. tax. If the information provided in the certificate changes within the 90 day period prior to the interest payment date, the person providing such statement must so inform the U.S. Person within 30 days of the change. A certificate provided by a clearing organization must be based on a written statement from the member organization to which the interest is paid that the beneficial owner of the interest is not a U.S. Person.
\textsuperscript{223} Id.
tax from interest payments made after certain dates. The type of confirmation required depends on the identity of the recipient of the interest payment.

If interest on a Targeted Registered Obligation is paid to a Financial Institution or to a member of a clearing organization after January 15, 1986, which member is the beneficial owner of the obligation, the Withholding Agent is authorized to withhold U.S. tax from such interest payment unless it receives a certificate from the recipient in accordance with the procedures specified in the Temporary Regulations.

The initial certificate provided to a Withholding Agent with respect to each Targeted Registered Obligation held (and every other Targeted Registered Obligation to be acquired and held by the person providing the certificate during the period beginning on the date of the certificate and ending on the date the next certificate is required to be provided) must state:

1. the identity and address of the certifier;
2. that the beneficial owner of the Targeted Registered Obligation will not be a U.S. Person on each interest payment date while the certifier holds the obligation; and
3. if the certifier is a Financial Institution which is holding or will be holding the obligation on behalf of a beneficial owner, that the certifier will provide an appropriate U.S. beneficial ownership notification to the Withholding Agent.

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224. See supra note 221 and accompanying text.
225. For purposes of these certification requirements, a “clearing organization” is an entity which is in the business of holding obligations for member organizations and transferring obligations among such members by credit or debit to the account of the member without the necessity of physical delivery of the obligation. Temp. Treas. Reg. § 35a.9999-5, Q&A-14(i)(B), T.D. 8046, 50 Fed. Reg. 33,526 (1985).
226. Temp. Treas. Reg. § 35a.9999-5, Q&A-12, Q&A-15(i)(A), T.D. 8046, 50 Fed. Reg. 33,527 (1985). Where no previous certificate with respect to a Targeted Registered Obligation has been provided to the Withholding Agent by the recipient of the interest, the certificate must be provided within the period beginning 90 days prior to the first interest payment date on which the recipient holds the obligation. The Withholding Agent may, in its discretion, withhold U.S. tax from an interest payment if this certificate is not received by the date 30 days prior to the interest payment. Thereafter, the certificate must be filed on an annual basis with respect to the Targeted Registered Obligation within the period beginning January 15 and ending January 31 of each year. Temp. Treas. Reg. § 35a.9999-5, Q&A-15(i)(A), T.D. 8046, 50 Fed. Reg. 33,527 (1985).

If the initial certificate with respect to a Targeted Registered Obligation is provided during the period beginning on January 15 and ending on January 31 of any year, then no certificate need be provided during such period in such year. Id. A certificate must be retained in the records of the Withholding Agent for four calendar years from the end of the calendar year in which it is received. The Withholding Agent is not required to file a Form 1042S to report payments of interest made with respect to Targeted Registered Obligations held by the certifier within the period beginning with the certificate date and ending on the last date for filing the next certificates. Temp. Treas. Reg. § 35a.9999-5, Q&A-15(i)(F), T.D. 8046, 50 Fed. Reg. 33,528 (1985).

228. This statement need not be made for any certificate required to be filed with the Withholding Agent during the period beginning January 15 and ending on January 31, 1986 if the Targeted Registered Obligation was acquired by the certifier on or before September 19, 1985. Temp. Treas. Reg. § 35a.9999-5, Q&A-15(iv)(A), T.D. 8046, 50 Fed. Reg. 33,528 (1985).
229. See infra notes 237-243.
(and to a clearing organization that is not a Withholding Agent where a member organization is required to furnish the clearing organization with a statement)\textsuperscript{230} in the event such certificate (or statement provided by a member organization to a clearing organization that is not a Withholding Agent) is or becomes untrue with respect to any obligation.\textsuperscript{231}

In addition to this information, each subsequent annual certificate with respect to a Targeted Registered Obligation must state that, beginning at the time the last preceding certificate was provided and while the certifier held the obligation at any time since the provision of this last certificate, either

(1) the beneficial owner of the obligation has not been a U.S. Person on each interest payment date,\textsuperscript{232} or
(2) if the certifier is a Financial Institution holding the obligation on behalf of the beneficial owner, the beneficial owner has been a U.S. Person on one or more specified interest payment dates and the certifier has forwarded or will forward the appropriate U.S. beneficial ownership notification\textsuperscript{233} to the Withholding Agent in the manner prescribed by the Temporary Regulations.\textsuperscript{234}

Each certificate must identify the Targeted Registered Obligation with respect to which it is given and which is being held by the certifier at the time the certification is made.\textsuperscript{235} If the Withholding Agent pays interest to a depository of a clearing organization, the clearing organization must provide the certificate to the Withholding Agent.\textsuperscript{236}

If on any interest payment date after a Targeted Registered Obligation was acquired by the person making the certification the beneficial owner of the obligation is a U.S. Person, then the recipient of the interest payment must furnish the Withholding Agent with a U.S. beneficial ownership notification within 30 days after such date. This notification must include a statement that (1) the beneficial owner has been a U.S. Person on a specified

\textsuperscript{230} See infra note 236.


\textsuperscript{232} The certificate provided to the Withholding Agent relates only to ownership of the Targeted Registered Obligation on interest payment dates, not to any period between such dates. This rule is consistent with the rules provided in Treasury Regulation § 1.1441-4(h) with respect to the withholding of tax on the sale of bonds between interest payment dates. However, the IRS has announced that it is studying the desirability of this provision and any changes thereto would be made in future Treasury Regulations on a prospective basis only. See Preamble to Temp. Treas. Regs., T.D. 8046, 50 Fed. Reg. 33,522 (1985).

\textsuperscript{233} See infra notes 237–243 and accompanying text.


\textsuperscript{235} Temp. Treas. Reg. § 35a.9999-5, Q&A-14(i)(C), T.D. 8046, 50 Fed. Reg. 33,527 (1985). A Targeted Registered Obligation is identified if it or the larger issuance of which it is a part is described on a list of all Targeted Registered Obligations held by or on behalf of the certifier and the list is attached to, and incorporated by reference into, the certificate. Id.

\textsuperscript{236} Temp. Treas. Reg. § 35a.9999-5, Q&A-14(i)(D), T.D. 8046, 50 Fed. Reg. 33,527 (1985). Any certificate provided by a clearing organization must state that the organization has received a statement from each member, regardless of whether the member is a Financial Institution, which complies with the rules set forth in Q&A-14 and Q&A-15 as if the clearing organization were the Withholding Agent. Temp. Treas. Reg. § 35a.9999-5, Q&A-14(i)(E), T.D. 8046, 50 Fed. Reg. 33,527 (1985).
interest payment date, (2) the owner has provided a Form W-9\(^237\) (or a substantially similar substitute form) to the person providing the notification, and (3) the person providing the notification has been and will comply with any applicable information reporting requirements. When the person providing the notification is neither a Controlled Foreign Corporation\(^239\) nor a foreign corporation whose interest payments would constitute U.S. Source Interest,\(^240\) the person must attach to the notification a copy of the Form W-9 (or a substantially similar substitute form) provided by the beneficial owner. When a person providing the U.S. beneficial ownership notification does not attach to it a copy of the Form W-9 (or a substantially similar substitute form), the person must state that it is either a Controlled Foreign Corporation or a foreign corporation whose interest payments constitute U.S. Source Interest.\(^241\)

If either a Form W-9 (or a substantially similar substitute form) or the statement described in the preceding paragraph is not attached to the U.S. beneficial ownership notification, the Withholding Agent is required to withhold U.S. tax on any interest payment made after the Withholding Agent has received the notification unless such form or statement (or a statement that the beneficial owner of the Targeted Registered Obligation is no longer a U.S. Person) is received before the interest payment date from the person who provided the notification (or its transferee).\(^242\) If this person provides a certification during the period beginning on the next January 15 and ending on the next January 31, a Withholding Agent generally is not required to withhold tax during the year following such certification (unless such person again provides a U.S. beneficial ownership notification without attaching a Form W-9 or acceptable substitute form).\(^243\)

With respect to interest paid after September 19, 1985 on a Targeted Registered Obligation to the beneficial owner of the obligation that is neither a Financial Institution nor a member of a clearing organization, the beneficial owner must generally furnish the Withholding Agent a Form W-8 (or a substantially similar substitute form) in order to avoid the imposition of U.S.

\(^{237}\) See supra note 215 and accompanying text.


\(^{239}\) See supra note 83 and accompanying text.

\(^{240}\) See supra note 8.

\(^{241}\) Temp. Treas. Reg. § 35a.9999-5, Q&A-15(i)(C), T.D. 8046, 50 Fed. Reg. 33,527 (1985). A Withholding Agent that receives a Form W-9 (or substantially similar form) must send a copy of the form to the IRS within 30 days after receiving it and must attach a statement that the Form W-9 or substitute was provided pursuant to the Temporary Regulations for a U.S. Person who has owned a Targeted Registered Obligation on one or more interest payment dates. Id.


\(^{243}\) Id.
withholding taxes on such interest payments.\textsuperscript{244} However, a Withholding Agent that is a foreign branch of a Financial Institution that is a U.S. Person need not receive any statement or certificate from the beneficial owner in order to avoid withholding U.S. taxes from the interest paid to the beneficial owner, provided such owner furnishes the Withholding Agent with documentary evidence\textsuperscript{245} that it is not a U.S. Person.\textsuperscript{246} If, on any interest payment date after the Targeted Registered Obligation was acquired by the beneficial owner, the beneficial owner is a U.S. Person, the beneficial owner must so inform the Withholding Agent within 30 days after such interest payment date and must provide a Form W-9 (or a substantially similar substitute form) to the Withholding Agent if it has not already provided such a form within the same calendar year.\textsuperscript{247}

In accordance with I.R.C. § 871(h)(4), the Secretary of the Treasury may determine in appropriate cases that a certificate or statement by any person or class of persons does not satisfy the requirements of that statutory provision, as prescribed by the Treasury Regulations promulgated thereunder.\textsuperscript{248} In such a case, all payments of interest that would otherwise qualify as Portfolio Interest to that person become subject to U.S. withholding tax.\textsuperscript{249}

\subsection*{B. Exemptions from Information Reporting and Backup Withholding}

\subsubsection*{1. Payments of Portfolio Interest on Bearer and Registered Obligations}

Payments of Portfolio Interest\textsuperscript{250} outside the United States on a bearer debt obligation issued by a U.S. corporation or a Controlled Foreign Corporation\textsuperscript{251} are, in general, exempt from information reporting and backup withholding unless the payor has actual knowledge that the payee is a U.S.


\textsuperscript{246} As in the case of a Form W-8, the documentary evidence must be provided to the Withholding Agent within the period beginning 90 days prior to and ending on the first interest payment date on which the Withholding Agent pays interest to the beneficial owner, and the Withholding Agent may withhold U.S. taxes if the documentary evidence is not received by the date 30 days prior to the interest payment. See supra note 233.


\textsuperscript{248} See supra note 203 and accompanying text.


\textsuperscript{250} See supra notes 73-117 and accompanying text.

\textsuperscript{251} See supra notes 82-83 and accompanying text.
Further, the payment or collection of Portfolio Interest outside the United States by a person acting in its capacity as a Middleman with respect to such payment or collection is also generally not subject to information reporting or backup withholding.

The Temporary Regulations, however, require information reporting with respect to Portfolio Interest on a bearer debt obligation paid or collected outside of the United States by a Middleman which is either a U.S. Person (including a foreign branch of a U.S. bank), a Controlled Foreign Corporation, or a foreign corporation deriving more than 50 percent of its aggregate worldwide gross income for a specified period from business activities in the United States unless:

1. the payee is an Exempt Recipient, or
2. the Middleman has documentary evidence in its files that the payee is not a U.S. Person (e.g., a written indication from the beneficial owner of the obligation on an account application that the owner is a Foreign Person).

The Temporary Regulations do not currently impose backup withholding on such Middlemen in respect of interest payments collected for their U.S. customers, even though the payments are subject to information reporting. However, the issue of whether backup withholding should apply in these cases remains under consideration by the Treasury Department. Any changes in the Temporary Regulations in this regard would have prospective effect only. The Temporary Regulations now clearly provide that foreign branches of foreign Financial Institutions and other foreign corporations collecting payments of Portfolio Interest outside of the United States as Middlemen generally are not required to file information returns or impose backup withholding in respect of any payments of Portfolio Interest.

252. Temp. Treas. Reg. § 35a.9999-5(a), Q&A-2, -3 (1984). To determine whether an interest payment is made outside the United States, see Temp. Treas. Reg. § 35a.9999-3, Q&A-37 (1984). However, for interest paid after November 20, 1984 on obligations issued after September 21, 1984, payments will not be considered to be made outside of the United States if the interest is paid to an address by mail or by electronic transfer. Temp. Treas. Reg. § 35a.9999-5(a) Q&A-3 (1984). For a comparison of these provisions with pre-1984 requirements for information and backup withholding, see supra notes 41-56 and accompanying text.

253. See Temp. Treas. Reg. § 35a.9999-4T, Q&A-5 (1984); T.D. 7972, 1984-44 I.R.B. 12. Mere evidence that the payee resides at a foreign address is not sufficient. The Treasury Department and the IRS currently are considering the appropriate evidentiary standard for determining whether a person is a Foreign Person. The Temporary Treasury Regulations indicate that the required evidence may include a written indication from the payee or, with respect to payments made after November 21, 1984, an affidavit of an employee of the Middleman based on documentary evidence supporting the belief that the payee is a Foreign Person. Id.

254. Id.


256. Id.

257. Temp. Treas. Reg. § 35a.9999-4T, Q&A-5, T.D. 7972, 1984-44 I.R.B. 12. As originally published on August 22, 1984, the provisions in the Temporary Regulations relating to information reporting and backup withholding indicated that all Withholding Agents would be subject to these compliance rules, including foreign branches of foreign banks. However, in apparent reaction to the concern of foreign banks in this regard, the Treasury Department amended the Temporary Regulations on August 27, 1984 to expressly provide for the limitations on information
With respect to the application of information reporting requirements to payments of Portfolio Interest to Foreign Persons, the Temporary Regulations impose more stringent documentary evidence standards on Middlemen which are foreign branches of U.S. banks, Controlled Foreign Corporations, and foreign corporations with substantial U.S. business activities than on other Middlemen. Thus U.S.-related Middlemen must request information from their customers that the customers would not be required to furnish if they conducted their securities dealings with foreign securities firms.

No statutory support appears to exist for this discriminatory treatment. Comments filed on the Temporary Regulations indicate that such treatment likely will place U.S.-related securities firms (i.e., foreign branches of U.S. banks and foreign subsidiaries of U.S. securities firms) acting as Middlemen at a serious competitive disadvantage with respect to their foreign counterparts. This disadvantage would result from the fact that Foreign Persons can be expected to prefer to deal with foreign securities firms in order to avoid the documentary burdens which are imposed on U.S.-related securities firms under the Temporary Regulations.258 Further, compliance with the documentary evidence rule contained in the Temporary Regulations may cause foreign branches of U.S. banks to violate the bank secrecy laws of the foreign countries in which these branches are located.259

No information reporting or backup withholding is normally imposed on the payment of Portfolio Interest on a registered debt obligation (regardless of whether the obligation constitutes a Targeted Registered Obligation) if the payor does not have actual knowledge that the payee is a U.S. Person.260

2. Interest on Deposits With U.S. Financial Institutions

The Temporary Regulations also include rules regarding the applicability of information reporting requirements to interest paid on deposit obligations where a special statutory exception exempts the interest from U.S. withholding tax prior to the 1984 Act.261 These rules appear to overlap (and at times conflict) with those rules contained in the final regulations on information reporting issued by the Treasury Department in 1983 to incorporate...
the tax compliance rules added to the Code by TEFRA. While the Temporary Regulations do not address this overlap, a better approach would be to view the prior Treasury Regulations as continuing in effect, with the rules contained in the Temporary Regulations providing additional exceptions to the imposition of information reporting on deposit obligations.

a. Deposits of One Year or Less

The Temporary Regulations provide that payments of interest on a deposit obligation of a U.S. bank or savings and loan association with a maturity of one year or less (whether issued in bearer form or “in registered form”) are exempt from information reporting and backup withholding provided:

1. the Eurobond Registration Exemption Requirements are satisfied with respect to any such deposit obligation issued in bearer form;
2. the payments are made outside the United States;
3. the deposit is part of a larger single public offering of obligations;
4. the issuer or paying agent has no actual knowledge that the payee is a U.S. Person;
5. the face amount of the obligation is not less than $500,000;263
6. if issued “in registered form”, the obligation is registered in the name of an Exempt Recipient; and
7. the obligation contains a statement to the effect that the holder represents and warrants that it is not a U.S. Person (other than an Exempt Recipient) and that it is not acting on behalf of a U.S. Person (other than an Exempt Recipient).264

b. Deposits of More than One Year

Payments of interest on deposit obligations of a U.S. bank or savings and loan association with an original maturity of more than one year are exempt from information reporting and backup withholding if:

1. the payments are made outside the United States and the Eurobond Registration Exemption is satisfied;
2. the issuer or a paying agent does not have actual knowledge that the payor is a U.S. Person; and
3. the deposit obligations are part of a larger single public offering.265

These rules parallel those described with respect to interest on short-term deposit obligations issued by U.S. financial institutions.

262. See Treas. Reg. § 1.6049-5 (1983). For example, the Temporary Regulations impose additional restrictions on the eligibility of interest paid to Foreign Persons on deposit obligations for an exemption from information reporting which are not contained in Treasury Regulation § 1.6049-5. See infra notes 263–265 and accompanying text.
263. Comments on the Temporary Regulations suggest that this $500,000 limitation is too restrictive. See Statement submitted by Price Waterhouse to the Commissioner of Internal Revenue (October 22, 1984); Letter from the Section of Taxation of the American Bar Association to the Commissioner of Internal Revenue (December 6, 1984).
3. *Short-Term Discount Obligations*

Payments of original issue discount on debt obligations with an original maturity of 183 days or less (other than deposit obligations) are exempt from information reporting and backup withholding if the same conditions applicable to deposit obligations with an original maturity of one year or less are satisfied.\(^2\)\(^6\)\(^6\)\(^6\) Payments of original issue discount on a discount obligation with an original maturity of more than one year are subject to the same information reporting and backup withholding rules applicable to interest-bearing debt obligations.\(^2\)\(^6\)\(^8\)

4. *Payments of Principal*

Payments of principal upon the redemption or retirement of bearer debt obligations issued directly by a U.S. Person or deposit obligations issued by U.S. Financial Institutions are not subject to information reporting and backup withholding if:

1. the obligation is presented for retirement or redemption, or payment is otherwise made, at the office of the issuer or its agent outside the United States; and
2. the issuer or agent had no actual knowledge that the payee is a U.S. Person.\(^2\)\(^6\)\(^9\)

The same rule applies to payments of principal upon the redemption or retirement of obligations issued “in registered form” if the obligations are registered in the name of an Exempt Recipient.\(^2\)\(^7\)\(^0\)

Notwithstanding these rules, a Middleman or a person otherwise acting as a broker with respect to a bearer or registered debt obligation is generally subject to information reporting unless:

1. the beneficial owner of the obligation is an Exempt Recipient; or
2. the Middleman or broker has documentary evidence in its files that the beneficial owner is a Foreign Person.\(^2\)\(^7\)\(^1\)

Foreign offices of foreign brokers, however, remain exempt from information reporting and backup withholding requirements with respect to principal payments except in the case of foreign brokers that are Controlled Foreign Corporations or foreign corporations whose income is derived principally from a trade or business in the United States.\(^2\)\(^7\)\(^2\)

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\(^2\)\(^6\). *See supra* notes 263–264 and accompanying text.


\(^2\)\(^6\)\(^8\). *See supra* notes 252–260 and accompanying text.


\(^2\)\(^7\)\(^0\). *See supra* note 42 and accompanying text.

\(^2\)\(^7\)\(^1\). *See supra* note 194 and accompanying text.

C. Estate Tax Exemption

In addition to repealing U.S. withholding tax on Portfolio Interest, section 127 of the 1984 Act also eliminates any potential federal estate tax liability of nonresident alien individuals\textsuperscript{273} dying after July 18, 1984 on debt obligations issued after that date the income from which would have been exempt from U.S. withholding tax (regardless of qualifying as Portfolio Interest or otherwise) if received by the decedent at the time of his or her death.\textsuperscript{274}

Since a nonresident alien is potentially subject to U.S. federal estate tax liability only with respect to property located in the United States, section 127 of the 1984 Act accomplishes its aims by providing that certain debt obligations issued after July 18, 1984 will be considered property located outside of the United States for U.S. estate tax purposes if the interest income thereon would not be subject to U.S. withholding tax if received by the decedent at the time of his or her death.\textsuperscript{275} These debt obligations include:

1. deposits with banks, savings and loan associations and similar financial institutions;
2. deposits with a foreign branch of a domestic corporation or partnership which branch is engaged in a commercial banking business; and
3. debt obligations the interest on which qualifies as Portfolio Interest (without regard to whether a Form W-8 is received in the case of registered obligations).

The repeal of the U.S. estate tax exception appears consistent with the Congressional intent underlying the repeal of the U.S. withholding tax on Portfolio Interest, since it should serve to encourage the purchase by Foreign Persons of the debt obligations of U.S. Persons and facilitate the access of U.S. Persons to international capital markets.

IV. Effects of the Withholding Tax Repeal on International Capital Markets

The immediate effect of the withholding tax repeal apparently advanced Congress' intention to enhance the access of U.S. corporations to foreign capital markets and to increase the number of U.S. corporations issuing debt obligations overseas. Immediately after the repeal of the withholding tax in July 1984, a significant increase occurred in the number of U.S. corporations making direct issuances of debt obligations in the Eurobond market.\textsuperscript{276} Since

\textsuperscript{273} Section 138 of the 1984 Act added § 7701(b) to the Code to provide a statutory definition of the term “nonresident alien.” Prior to the 1984 Act, the term “nonresident alien” was not defined anywhere in the Code, although the Treasury Regulations did provide such a definition which generally made the determination of an alien’s resident status for federal income tax purposes dependent upon a subjective analysis of the particular facts and circumstances involved. See Treas. Reg. § 1.871-2(b) (1957).

\textsuperscript{274} 1984 Act, supra note 1, § 127(g)(2). See supra note 66 and accompanying text.

\textsuperscript{275} This change is effected by amending I.R.C. § 2105(b). See 1984 Act, supra note 1, § 127(d).

\textsuperscript{276} Eurobond issues during 1984 totalled approximately $20 billion, with approximately $14 billion of this amount issued after July 18, 1984. In January 1985, $2.5 billion of dollar
the beginning of 1985, however, the Eurobond market has seen more debt issuances than the apparent demand dictates, and many investment banking firms underwriting such issuances have sustained substantial losses as a result of this market saturation.\textsuperscript{277} The withholding tax repeal has not yet resulted in a dramatic increase in the purchase by Foreign Persons of the debt obligations of U.S. issuers.\textsuperscript{278} However, this repeal has had the expected effect of narrowing the yield spreads between the debt obligations of U.S. issuers in the U.S. market and in the Eurodollar market and of increasing the demand by speculators for debt obligations issued by the U.S. Treasury.\textsuperscript{279}

Another effect of the enactment of section 127 of the 1984 Act has been to encourage other countries to consider amending their internal tax laws to repeal their own withholding tax on certain types of interest. France and the Federal Republic of Germany, for example, have made announcements that they intend to repeal their withholding taxes on interest paid on government bonds so as to enable debt obligations issued by their governments to be competitive in the Eurobond market with debt obligations issued by U.S. private and governmental issuers.\textsuperscript{280}

Despite the short-term ameliorative effects of the repeal of the U.S. withholding tax on the access to foreign capital markets by U.S. Persons, certain of the views expressed in the Temporary Regulations have caused significant concern to the financial community. First, the restrictive definition of Portfolio Interest contained in the Temporary Regulations may significantly affect the types of debt obligations to be sold by U.S. corporations to Foreign Persons in the future.\textsuperscript{281} Second, the certification requirements contained in the Temporary Regulations with respect to Non-Targeted Registered Obligations are too cumbersome and complex and will impose significant operational problems and additional administrative expenses for U.S. Eurobond underwriters.\textsuperscript{282} In addition, these certification requirements are likely to substantially discourage Foreign Persons from purchasing these obligations — a result which may increase the number of outstanding bearer obligations and the potential for tax compliance problems in the United States. Third, the Temporary Regulations may have a discriminatory effect on U.S. financial institutions and investment banking firms (and their foreign branches) as compared with their foreign counterparts. It is difficult to justify on the basis of sound tax policy the placing of U.S. participants in the Eurobond market

denominated debt obligations issued by nongovernmental entities had been sold in the Eurobond market. 26 Tax Notes 404 (1985).

\textsuperscript{277} See N.Y. Times, Feb. 14, 1985, at D-1, col. 3.

\textsuperscript{278} Am. Banker, Aug. 28, 1985, at 2, col. 3.

\textsuperscript{279} Id.


\textsuperscript{281} See supra notes 112--117 and accompanying text.

\textsuperscript{282} See supra notes 200--218 and accompanying text.
at a competitive disadvantage with respect to foreign participants — a result which is likely to occur under the Temporary Regulations.\textsuperscript{283}

Many Foreign Persons apparently are not convinced that the repeal of the U.S. withholding tax on interest is permanent. Support for this skepticism can be found in proposed legislation to prospectively reinstate this U.S. withholding tax and repeal the rules set forth in the 1984 Act.\textsuperscript{284} In response to the concern of Foreign Persons regarding the permanency of the repeal of the U.S. withholding tax, bearer obligations issued by U.S. corporations after July 18, 1984 have continued to contain “gross up” and call provisions to protect investors from any subsequent changes in law or regulations which would repeal the exemption from U.S. withholding tax, impose backup withholding or information reporting, or impose new certification requirements jeopardizing the anonymity of the Foreign Persons owning these obligations.\textsuperscript{285}

Finally, the long-term effect of the repeal of the U.S. withholding tax on interest will depend in large part on the manner in which the Treasury Department responds to the criticisms of the Temporary Regulations when the Department issues these regulations in final form. In addition to consideration of the relevant compliance issues, the extent to which the Treasury Department will be sympathetic to these criticisms may be based in part on the continuing performance of Eurobond issuances by domestic corporations under the rules now prescribed in the Temporary Regulations.

\textsuperscript{283} See supra notes 216–218 and accompanying text.


\textsuperscript{285} See, e.g., Texaco Capital, Inc., Amendment to Offering Circular (September 10, 1984); Merrill Lynch & Co., Inc., Preliminary Extel Card (September 18, 1984) (available from the International Tax and Business Lawyer).