REPORT #556

TAX SECTION

New York State Bar Association

Report of the Committee on Foreign
Activities of United States Taxpayers
With Respect to Regs. $35a.9999-5(f)

January 19, 1987

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Copies of the attached letter dated 1/19/87 enclosing the Report of the Committee on Foreign Activities of U.S. Taxpayers With Respect to Regs. §35a.9999-5(f) were sent to the following:

The Honorable J. Roger Mentz
Assistant Secretary (Tax Policy)
Department of the Treasury

The Honorable David H. Brockway
Chief of Staff
Joint Committee on Taxation

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REPORT # 556

TAX SECTION

New York State Bar Association

January 19, 1987

The Honorable Lawrence B. Gibbs
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Dear Commissioner Gibbs:

The enclosed report of the New York State Bar Association Tax Section comments on withholding tax regulations published on December 19, 1986 by the Internal Revenue Service.

The report questions whether the amendments should be allowed to become effective as presently drafted. We have suggested alternative approaches to the problems addressed by the amendments that we consider to be both consistent with the statute and sensible tax policy.

I hope the report is useful to you.

Sincerely,

Richard G. Cohen
Chairman

RGC:jl
Enclosure

REPORT #556

January 19, 1987

Report of the Committee on Foreign Activities of United States Taxpayers With Respect to Regs. §35a.9999-5(f)

On December 19, 1986 the Internal Revenue Service issued Regs. §35a.9999-5(f), relating to the repeal of the 30% withholding tax on interest and dealing with the exclusion from the repeal for interest that is paid to 10% or greater shareholders of, or controlled foreign corporations related to, the issuer.[*] These regulations (hereafter, the "Amendments") were issued as both proposed and amended regulations and are scheduled to go into effect on January 20, 1987 without the opportunity for prior comment or hearings.

For the reasons set forth below, we have serious reservations as to whether the Amendments in their present form are a supportable interpretation of the statute or represent sensible tax policy. Accordingly, we recommend that the Amendments not be allowed to go into effect on January 20 but be left outstanding in proposed form until comments thereon can be considered.[**] We have suggested below (see Recommendation and Specific Comments on the Amendments) approaches to the

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[*] T.D. 8111, published in the Federal Register on December 19, 1986.

[**] This report was prepared by Committee consisting of Paul Butler, John A. Corry, Esta M. Eiger, Steve Gordon, Richard M. Leder, Leslie B. Samuels and Willard B. Taylor, who was the principal draftsman. Comments were received from William L. Burke, Peter C. Canellos, Herbert L. Camp, Richard G. Cohen, Dale S. Collinson, Robert A. Jacobs, Mathew M. KcKenna, Charles M. Morgan, David Sachs, Donald Schapiro and George Zeitlin.

problems addressed by the amendments that we consider to be consistent with the statute and sensible tax policy.

The Repeal of the 30% Withholding Tax

The Tax Reform Act of 1984 repealed the 30% with-holding tax on “portfolio” interest, including original issue discount, paid to nonresident aliens and foreign corporation. Under the statute, “portfolio” interest does not include interest paid to a 10% or greater shareholder or a controlled foreign corporation related to the payor or interest paid to a bank on an extension of credit made pursuant to loan agreement entered into in the ordinary course of the bank’s business; and, under regulations issued in August of 1984 (hereafter, the “August Regulations”), “portfolio” interest was also interpreted to exclude interest on obligations that were not “registration-required” obligations within the meaning of Section 163(f)(2)(A) of the Internal Revenue Code.

While the exclusion under the August Regulations of interest on obligations that were not registration-required excluded interest on obligations not “of a type” offered to the public, the “of a type” test looked to the kind of obligation that was issued, not to whether it was privately placed or publicly offered, and thus it did not exclude from the repeal interest on privately placed obligations.[*] In testimony before

[*] See Temp. Regs. §5f.103-1(b)(1).

the Ways and Means and Senate Finance Committees,[*] the Treasury Department urged that the Internal Revenue Code be amended to exclude interest on privately placed obligations, but this proposal was not adopted in the Tax Reform Act of 1986. The basis for the Treasury's view was that the rationale of the repeal applied only to publicly offered obligations and that other countries did not generally exempt interest on privately-placed obligations.

With the foregoing exceptions, until the Amendments, the repeal of the 30% withholding tax extended to all interest paid by U.S. borrowers, subject to compliance with rules relating to the issuance of obligations in bearer form or, in the case of registered form obligations, to certification requirements set out in the statute and the August Regulations.

The Amendments

Changes to the regulations that were issued simultaneously with the Amendments[**] retroactively eliminate the rule in the August Regulations that had excluded from the repeal interest paid on obligations that were not registration-required, with the consequence that the repeal now extends to interest on obligations issued after the effective date of the repeal which are not "of a type" offered to the public or otherwise not registration-required. For obligations issued after January 20, 1987, however, the scope of the repeal is drastically, and we believe unjustifiably, narrowed by the introduction in the

[*] Statements of J, Roger Mentz, Assistant Secretary for Tax Policy, Before the Committee on Ways and Means (May 16, 1985) and the Senate Finance Committee (June 5, 1985).

[**] Regs. §35a.9999-5(a) and (b), also published as part of TD 8111.

Amendments of a presumption that all interest is deemed to be paid to a 10% or greater shareholder or related controlled foreign corporation, and thus to be ineligible for the repeal, unless one of several tests is satisfied,* as follows:

(1) The interest is paid on an obligation that is both publicly offered and listed on a securities exchange. Trading in over-the-counter market will not satisfy the listing requirement.

(2) Both the issuer and the holder are publicly-traded corporations. An issuer or holder will be publicly traded only if no class of the issuer's stock, other than non-voting preferred stock that is limited as to dividends and in liquidation, is traded in bearer form and only if a substantial portion of each class of its stock, other than non-voting preferred stock that is limited as to dividends and in liquidation, is traded on a securities exchange or in the over-the-counter market.

(3) Either the issuer or the holder is a corporation that is publicly traded, within rule (2), but the other is not, and the non-traded or non-corporate party has provided the issuer or the other person required to withhold with a statement which, among other items, includes information identifying by name its ultimate individual beneficial owners. This information must be periodically renewed. As an exception, certain mutual insurance companies,

* All the tests assume, as we do in this report, that the issuer or other paying agent does not have actual knowledge that the interest is paid to a 10% or greater shareholder or related controlled foreign corporation.

retirement plans, charitable organizations and foreign governments do not have to provide information with respect to ultimate individual ownership.

(4) Neither the issuer nor the holder is a corporation whose stock is publicly traded and the issuer or other withholding agent has the certificate summarized in rule (3) for both the issuer and holder.

In effect, the Amendments establish a series of hurdles which, if met, permit the payment of interest without withholding, but otherwise impose withholding tax. Thus, interest on obligations issued after January 20, 1987 may be paid without withholding tax if the obligation is publicly offered and listed on a securities exchange; if the obligation is not publicly offered or is publicly offered but is not listed on a securities exchange, interest may be paid without withholding tax if both the issuer and the holder are corporations whose stock is publicly traded; if the obligation is not publicly offered or is publicly offered but is not listed, and either the issuer or the holder or both is not a corporation which is publicly traded, interest may be paid without withholding tax only if there is a certificate or certificates with respect to ultimate individual beneficial ownership of each non-corporate or non-traded party.

In form the Amendments purport to construe the circumstances under which a withholding agent must treat interest as paid to a 10% or greater shareholder or related controlled foreign corporation. The inquiries into whether or not obligations are publicly offered and listed on a securities exchange or the stock of the issuer or holder is publicly traded, however, have no necessary relevance to the likelihood that the obligations will be held by a 10% or greater shareholder or a

related controlled foreign corporation. The practical effect of the amendments, moreover, will be to exclude from the withholding tax repeal interest on most obligations that are not publicly offered or are publicly offered but not listed on a securities exchange. In theory, interest on other obligations may still qualify, but the circumstances in which issuers and lenders will all be publicly traded corporations are limited, given the narrow and highly technical definition of publicly traded; and it is extremely unlikely, given the attribution of ownership rules, that a foreign lender could, even if it was willing to do so, provide the information required by the certificate. This is particularly likely to be so in the case where obligations are sold to a number of holders who are unrelated to the issuer.

For these reasons, we conclude that the Amendments, in their present form, must be analyzed as in effect excluding from the repeal most interest on obligations not covered by the first rule in the Amendments -- that is, interest on privately placed obligations and on publicly offered obligations that are not listed on a securities exchange.

Statutory Basis for the Amendments

Whether viewed as an interpretation of the exclusion for interest paid to 10% or greater shareholders and related controlled foreign corporations or as an exclusion for interest paid on privately placed obligations, we do not think that the Amendments, as presently written, are supported by the statute.

As an explicit exception to the general obligation to withhold on income subject to 30% withholding tax, Section 1441(c)(9) of the Internal Revenue Code provides that withholding is required from otherwise eligible “portfolio” interest only if

the withholding agent "knows, or has reason to know" that the interest is paid to a 10% or greater shareholder or related controlled foreign corporation. Most obligations sold in foreign capital markets are sold in bearer form to holders who insist on anonymity. This statutory exception, never mentioned in the Amendments or the preamble thereto, was provided precisely to ensure that withholding agents would not have to make special inquiries into the identity of recipients in order to pay otherwise eligible "portfolio" interest free of withholding tax. The legislative history is specific on that point*.

Although the Internal Revenue Service has general authority under Sections 1441 and 1442 of the Internal Revenue Code to require withholding on payments to unidentified recipients**, that is not a basis for regulations targeted at interest on obligations that are not publicly offered or are publicly issued but not listed on a securities exchange. There is no suggestion in the legislative history that the draftsmen of the withholding tax repeal were attempting to impose,

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* See Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, stating (at p. 397):

> "Under the Act, an explicit duty to deduct and withhold tax at the 30-percent rate arises only if the person otherwise subject to the duty knows, or has reason to know, that the interest is subject to tax at the 30-percent rate because"

it is paid to an ineligible recipient.

See also, S. Prt. 98-169, 98th Cong. 2d Sess. (1984) at 423-24.

** See S. Prt 98-169, 98th Cong. 2d Sess (1984) at 424, stating that the "bill will not affect the authority [to require withholding] when the payor does not know the identify of the beneficial owner of the securities."

or to authorize the Treasury Department to impose, a duty to inquire in to facts which could not be readily ascertained as a precondition for concluding that there was no “reason to know” that the interest was being paid to an ineligible recipient.

The “knows” or “has reason to know” language is used throughout the Internal Revenue Code and Regulations, always in its customary and ordinary sense of requiring actual knowledge or the existence of facts that would establish actual knowledge by a reasonable person.[*] No principle of interpretation known to us justifies presuming that an issuer or other withholding agent “knows” or has “reason to know” that interest on an obligation that is not publicly issued, or is publicly issued but is not listed on a securities exchange, is being paid to a related party unless the issuer and lender are publicly traded corporations or the withholding agent can identify the ultimate individual beneficial owners of the issuer and lender. The Amendments effectively reverse the presumption of the statute.

The Amendments are an even more problematic exercise of regulatory authority if viewed as an exclusion of interest paid on privately placed obligations. Private placements and offerings of non-listed obligations were well-known prior to the repeal of the withholding tax in the Tax Reform Act of 1984 and nothing in the statute or its legislative history indicates that they were to be excluded from the repeal. The Treasury's subsequent testimony before the Ways and Means and Finance Committees

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[*] E.g., Sections 66(c) (innocent spouse exception For liability in respect of income from community income), 999(a) (liability to file international boycott reports) and 6013(c) (innocent spouse exception for joint return liability).

that a statutory amendment was required to exclude interest on private placements from the repeal concedes this point. The August Regulations, which were issued shortly after the repeal, did not exclude private placements; and the retroactive elimination of the requirement that obligations be registration-required supports the view that the withholding repeal applies equally to obligations that were not "of a type" publicly offered or traded.

We suggest that it is inappropriate for the Treasury Department now to assert, more than two years after the statute was enacted and regulations issued thereunder and after having tried and failed to get a statutory amendment, that it may by regulation exclude interest on obligations that are not publicly offered.

Recommendation

For the foregoing reasons, we believe that the Amendments, as presently written, are not a supportable interpretation of the statute and should not be adopted. In evaluating what might be provided in regulations, the Treasury Department and the Internal Revenue Service should consider the following:

1. Is there a need for regulations that implement the requirement that tax be withheld on interest paid to a 10% or greater shareholder or related controlled foreign corporation? Our concern is that any regulations implementing the requirement that tax be withheld, unless very narrowly targeted, will seriously interfere with the operation of the repeal. Absent special circumstances, U.S. corporations should be assumed to be responsible corporate citizens who will know when interest is

being paid to 10% or greater shareholders or related controlled foreign corporations and will withhold under the statutory "knows, or has reason to know" test. As a Committee, we are not aware that there are cases in which the benefits of the repeal are being claimed by 10% or greater shareholders or by related controlled foreign corporations and we therefore do not think this is an area of abuse. In addition, there are alternatives to regulations that would require withholding. For example, regulations under Sections 6038 and 6038A of the Internal Revenue Code could require the reporting by U.S. shareholders of interest received by controlled foreign corporations from related U.S. issuers and the reporting by U.S. issuers of interest paid to controlling foreign shareholders.[*]

2. If implementing regulations are issued, consideration should be given to the statutory basis for requiring withholding on interest paid to a 10% or greater shareholder or a related controlled foreign corporation. As noted, Section 1441(c)(9) of the Internal Revenue Code requires withholding on interest only if the withholding agent "knows, or has reason to know" that the interest is being paid to such a related person. Any regulations should require withholding only if the facts fairly establish a basis for believing that interest is being paid to a 10% or greater shareholder or a related controlled foreign corporation. The statute simply does not support regulations, such as the Amendments, which in

[*] We recognize that these provisions only apply to U.S. persons controlling the controlled foreign corporation and to U.S. persons that are controlled by foreign persons (and thus that they are not as broad as the exclusions from the repeal), but we believe that in the majority of cases the related controlled foreign corporation will be controlled by a single payor and that a U.S. corporation with a 10% or greater foreign shareholder will be controlled by that shareholder.

effect presume knowledge in almost every case in which obligations are not publicly offered and listed on a securities exchange. Regulations more narrowly targeted at, for example, privately placed obligations of a closely-held corporation whose shareholders at the time of issuance are known to include one or more 10% or greater foreign shareholders might be defensible if such regulations do not impose impractical certification or other obligations.

3. If implementing regulations are issued and they require certification of stock ownership, the certification requirement should take into account (a) the fact that it is virtually impossible for a corporation that has any degree of public ownership to ascertain the beneficial (much less the constructive) ownership of its publicly-held stock, (b) that lenders do not generally regard lending as a privilege for which they are prepared to meet unusual certification requirements, and (c) that no foreign lender is likely to be able, even if willing, to provide information with respect to the ownership of its stock. A lender in a private placement might reasonably be asked to certify that it does not actually own 10% or more of the stock of the issuer (and possibly that it is not part of a group that owns that amount of stock), but we doubt any foreign lender that is unrelated to the issuer will provide information with respect to the ownership of its stock or make representation with respect to the application of the constructive ownership rules of United States tax law.

Specific Comments on the Amendments

With respect to the specific provisions of the Amendments, we have the following comments that we think should be considered:

General

The Amendments have a marked tendency to bifurcate the securities markets between domestically and foreign issued obligations. This is contrary to the purposes of the repeal of the withholding tax and we question whether it is good tax policy.

For example, while issuers targeting obligations to foreign markets may list those obligations on a securities exchange in order to comply with the listing requirement of Paragraph (1) of Question and Answer 25, that step may not be taken when obligations are initially targeted for the domestic market, with the consequence that secondary market purchases of those obligations by foreign investors will be restricted. Likewise, if the requirement of Paragraph (3)(B) of Question and Answer 25 that an issuer has “no reason to believe” that underwriters are selling to 10% or greater shareholders or to related controlled foreign corporations is interpreted (as it may be) to require special precautions in underwriting papers, these will be inserted in documents for foreign but not domestic offerings, with the consequence that secondary market purchases of domestically issued obligations by foreign investors may be restricted.

Definition of “Publicly Issued”

(a) We question whether it makes no sense to require (as provided in Paragraph (1) of Question and Answer 25) that an obligation be listed on a securities exchange in order to be within the class of obligations that is not in effect subject to certification rules. A listing requirement plainly does not ensure public issuance, if that is its purpose, since it will

exclude obligations that are publicly distributed, including so-called Swiss franc private placements, medium term note programs and a number of domestically-issued obligations, such as obligations of the U.S. Government, the Agencies and mortgage-backed securities.*

(b) The requirement in Paragraph (3)(B) of Question and Answer 25 that an issuer, in the case of a firm commitment underwriting, “has no reason to believe” that sales will be made by underwriters to 10% or greater shareholders or related controlled foreign corporations seems at odds with the absence of any such requirement in Paragraph 3(A), relating to obligations sold by underwriters on a best efforts basis. Given the Amendments' interpretation of the statutory “knows, or has reason to know” language, moreover, the “has no reason to believe” requirement may be read to require an issuer make special inquiries as to whom ultimate purchasers of the obligations are.

(c) The permitted exceptions to the requirement in Paragraph (2) of Question and Answer 25 that an obligation not be subject to any Federal securities law restrictions on resales, etc. should be expanded to cover territoriality (i.e., prohibitions on offers and sales within the United States). We also question whether it is appropriate to exclude obligations that are privately placed in the U.S. because there are restrictions on resales in the U.S. in a case where there are no restrictions on offers or sales of those obligations outside of the United States to foreign persons.

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* In addition, the listing requirement appears to require that an obligation be listed on each interest payment date and thus would mean that an obligation would cease to be eligible under this rule if it were subsequently delisted or the exchange ceased to qualify. (We do not, on the other hand, believe that listing at inception is appropriate since some issues are not listed for several months after issuance.)

Definition of “Publicly Traded”

The definition in Question and Answer 26 of the circumstances under which a corporation will be treated as publicly traded is extremely narrow since a corporation can never be publicly traded if it has a single class of stock, other than a class of non-voting preferred that is limited as to dividends and in liquidation, that is issued or traded in bearer form or not traded to a substantial degree. A great many publicly held corporations will be excluded by this definition -- because, for example, of single class of non-traded stock or because it is customary in a foreign country to issue or trade shares in bearer form. The rule that permits a “look through” to ultimate individual shareholders in the case of a corporation that is a member of an affiliated group[*] is likewise narrow -- it would not, for example, cover a corporation owned by a consortium of financial institutions.

Form of Statement

(a) As applied to non-corporate issuers and holders, the rules of Question and Answer 27 are inadequate. As a practical matter, where either the issuer or the lender is not a corporation or has no stock, interest may be paid without withholding only if either (a) the non-corporate or non-stock party is a mutual insurance company with 500 or more policyholders, a foreign government, a retirement plan or a charitable organization within the meaning of Section 501(c)(3) of the Internal Revenue Code or (b) there is a

[*] In addition, the definition of an affiliated group may exclude insurance companies.

certification of ultimate beneficial ownership by individuals. This leaves out several classes of borrowers and lenders -- it will be rare indeed, for example, for a foreign charity to meet the detailed requirements of Section 501(c)(3) of the Internal Revenue Code.

(b) The requirement of Question and Answer 27 that a non-traded or non-corporate issuer or lender provide a certification as to ultimate beneficial ownership by individuals seems to us to be impossibly broad. As a practical matter, corporations that have any degree of public ownership are not able to identify the beneficial (much less the constructive) owners of their public stock. The required certification will operate as a prohibition on the issuance of obligations in cases where interest on the obligations can be paid free of withholding tax only if there is certicication.