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COMMENT

U.S. TAXATION OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS: A STRATEGY FOR THE INTERNATIONAL CAPITAL MARKET GAME

by Dwight Robert Shockney

As of September 1987, banks in the United States had accumulated liabilities to foreigners that exceeded $600 billion. Between 1980 and 1986, the total foreign-owned assets in the United States increased from $500 billion to $1.3 trillion. During the same period, the United States exchanged its role as the world's largest creditor nation for the role of the world's foremost debtor. The factors that contributed to the country's financial antithesis included the federal government's budget deficit and the international trade imbalance. Tax policies of the United States Government, however, also played a key role in changing the flow of international capital.

This Comment focuses on the taxation of foreign investments, especially the taxation of interest and dividend income. The Comment examines in Part I the historical development of foreign income tax statutes from 1909 through 1986. Although a considerable body of tax law deals with the treatment of foreign income for U.S. citizens and resident aliens, this Comment approaches the subject from the perspective of the nonresident alien and the foreign corporation whose investment decisions affect the U.S. economy.

Given the magnitude of the foreign capital market, the federal government's policy on the tax treatment of foreign investment income has a major impact on the U.S. economy. Unlike domestic tax policy, international tax policy must reflect an awareness that the United States occupies only a competitive, and not a dominant, position in the foreign capital arena. Part II of this Comment discusses the two major, but seemingly conflicting, tax stat-
utes that Congress enacted during the 1980s: (1) a significant tax exemption for foreign investment income in 1984, and (2) a complex dividend and interest surtax on foreign corporations in 1986. The contradictory nature of the legislation reflects the absence of a coherent international tax strategy. Congress should focus its capital-oriented tax policies on promoting domestic investment. At a minimum, Congress should reconcile its conflicting tax policies of simultaneously exempting foreign portfolio interest income from tax while assessing heavy tax rates on foreign business investment income. This Comment provides some recommendations in Part III for reconciling the objectives of foreign tax policy to those of domestic tax policy.

I. HISTORICAL DEVELOPMENT OF U.S. TAX ON FOREIGN ENTITIES

A. Early Stages of Foreign Tax Policy

The United States began taxing foreign corporations when Congress passed the Revenue Act of 1909 (1909 Act). Section 38 of the 1909 Act assessed an excise tax of one percent on the net income exceeding $5,000 of both domestic and foreign corporations. This statute applied to income that a foreign corporation generated from its business transactions as well as from its capital investments. The statute allowed a foreign corporation to make certain deductions to arrive at its taxable net income. After the adoption of the sixteenth amendment to the Constitution, Congress introduced an income tax system that applied to both foreign corporations and nonresident aliens. Section II(A)(2) of the Revenue Act of 1913 (1913 Act) imposed a one percent tax, referred to as the “normal income tax,” on the first $20,000 of each nonresident alien’s net income. Like the excise tax of the 1909 Act, this normal income tax applied with no distinction between income generated from business activity and income generated from capital investment. The 1913 Act also imposed the normal income tax on foreign corporations, but allowed deductions for losses and ordinary and necessary expenses. All corporations, domestic or foreign, that made annual or periodic payments of fixed or determinable income to another person subject to income tax encountered, for the first time, the U.S. tax system’s withholding obligations. The withholding system eliminated the need for most nonresi-

7. Revenue Act of 1909, ch. 6, 36 Stat. 11.
8. Id. § 38, 36 Stat. at 112.
9. Id.
10. Id., 36 Stat. at 113. The statute allowed deductions for all ordinary and necessary expenses, all losses sustained (including a reasonable allowance for depreciation), interest paid (subject to limitations), taxes paid, and dividends received from other corporations.
11. U.S. CONST. amend. XVI.
13. Id. § II(A)(2). On income above $20,000, the 1913 Act applied a graduated rate that reached a maximum of six percent on income in excess of $500,000. Id.
14. Id. § II(G)(a), 38 Stat. at 172.
15. Id. §§ II(G)(a), (b), 38 Stat. at 172-74.
16. Id. § II(D), 38 Stat. at 168. The withholding provision stated that all persons, business entities, or associations that controlled the receipt, disposal, or payment of “fixed or deter-
dent aliens to file tax returns.\textsuperscript{17}

Although Congress passed many revenue acts during the next twenty years,\textsuperscript{18} the first major complication arose with the passage of the Revenue Act of 1934 (1934 Act).\textsuperscript{19} Section 119(e) of the 1934 Act treated gains from the sale of property (including securities) as U.S. source income if the sale took place in this country.\textsuperscript{20} The Commissioner of the Internal Revenue Service issued regulations defining the place of sale as where the taxpayer marketed the property.\textsuperscript{21} Foreign investors could avoid the tax if they purchased American securities, deposited the certificates with their U.S. brokers, and then contracted for the sale abroad. Because they marketed the securities outside the United States, they incurred no U.S. tax liability.\textsuperscript{22} Mandatory withholding of tax did not provide a practical alternative to the easily circumvented tax return system since the United States taxed the foreign seller on his total annual income, an amount unknown at the time of the sale.\textsuperscript{23} The filing of returns and payment of tax on capital gains by nonresident aliens lapsed into a voluntary system with limited compliance.\textsuperscript{24}

The Revenue Act of 1936 (1936 Act)\textsuperscript{25} signaled a fundamental shift in the government's approach to taxing the U.S. income of nonresident aliens.\textsuperscript{26}

\textsuperscript{17} The 1913 Act specified a \$3,000 income level as the minimum filing requirement. \textit{Id.}

\textsuperscript{18} \textit{See, e.g.,} Revenue Act of 1926, ch. 27, 44 Stat. 9; Revenue Act of 1924, ch. 234, 43 Stat. 253; Revenue Act of 1921, ch. 136, 42 Stat. 227.

\textsuperscript{19} Revenue Act of 1934, ch. 277, 48 Stat. 680.

\textsuperscript{20} \textit{Id.} § 119(e), 48 Stat. at 717. This section treated income derived from the sale of personal property that a taxpayer purchased within the United States, but subsequently sold outside the United States, as income derived entirely from the country where the taxpayer sold the property. Conversely, the statute treated personal property that a taxpayer acquired outside the United States, but subsequently sold in the United States, as U.S. source income. \textit{Id.}

\textsuperscript{21} Treas. Reg. § 86.119-8 (1936). The Commissioner's choice of terminology contradicted the Board of Tax Appeals, which in several cases had previously defined the place of sale as the location where the seller passed title of the property to the buyer. See East Coast Oil Co. v. Commissioner, 31 B.T.A. 558 (1934) (oil sold under U.S. contract, but delivered to foreign port, generated no taxable income); Briskey Co. v. Commissioner, 29 B.T.A. 987 (1934) (U.S. corporation's home office generated no taxable income with sales orders because branch office in India fixed prices and collected payments); R.J. Dorn & Co. v. Commissioner, 12 B.T.A. 1102 (1928) (nonresident alien partner of New York partnership generated no taxable income from sale of goods through Cuban office to foreign customers).

\textsuperscript{22} \textit{See} Angell, \textit{The Nonresident Alien: A Problem in Federal Taxation of Income}, 36 \textit{COLUM. L. REV.} 908, 914 (1938).

\textsuperscript{23} \textit{Id.} at 911-12.

\textsuperscript{24} \textit{Id.} at 910. Angell provides the following illustration:

\begin{quote}
In the fall of 1934, the Commissioner of Internal Revenue sent broadcast to the countries of Europe circular letters calling attention to the requirements of the Federal law and threatening all manner of retribution upon the nonresident alien who failed voluntarily to come forward and file a return . . . . A storm of protest immediately arose, of such weight that the Treasury largely abandoned the effort.
\end{quote}

\textit{Id.}

\textsuperscript{25} Revenue Act of 1936, ch. 690, 49 Stat. 1648.

\textsuperscript{26} \textit{Id.} § 211, 49 Stat. at 1714.
The statute bifurcated aliens into two groups: (1) those who engaged in a trade or business or maintained a place of business in the United States; and (2) those who received only "fixed or determinable annual or periodical" income. The 1936 Act continued to tax the former group on all income from U.S. sources, while the latter group paid their taxes through withholding provisions on only their interest, dividends, rents, and similar income. This distinction exempted those aliens who were not engaged in a trade or business from paying any U.S. tax on capital gains. The 1936 Act also applied the same principle to foreign corporations, dividing these corporations into "resident corporations" and "nonresident corporations." Nonresident corporations, like nonresident alien individuals, paid tax through withholding on their fixed or determinable annual or periodic income. The exclusion of tax on capital gains for all nonresident foreign entities, corporate or otherwise, reflected a clear congressional design to encourage investment from abroad. Congress soon recognized, however, that the plan required some modifications.

The 1936 Act created inequity by imposing a relatively low flat withholding tax on aliens while assessing potentially higher progressive rates on U.S. citizens. To reduce the imbalance in tax treatment, the Revenue Act of 1937 further divided nonresident aliens not engaged in business into two classes on the basis of income. Aliens with gross income above $21,600 paid tax at rates applicable to U.S. citizens with the same income, while aliens with gross income below $21,600 continued to pay at the flat tax rate. Capital gains, however, remained nontaxable for both groups.

27. Id. § 211(b), 49 Stat. at 1714. This section dealt with the individual nonresident alien who engaged in a trade or business in the United States or maintained an office or place of business in the United States. This section held a nonresident alien liable for tax if he met the requirements of a two-part test: (1) presence in the United States for at least 90 days, and (2) aggregate compensation exceeding $3,000. Id.

28. Id. § 211(a), 49 Stat. at 1714. Section 211(a) generally assessed a flat 10% tax on regular or periodic nonbusiness income. Id. The residents of Canada and Mexico received preferential treatment in the form of lower rates made available by treaty. Id.


31. Revenue Act of 1936, § 231, 49 Stat. at 1717. Parallel in construction to § 211, § 231(a) dealt with nonresident corporations, while § 231(b) focused on resident corporations. Id.

32. Id. § 231(a), 49 Stat. at 1717. The Act applied a 15% tax rate to corporate nonbusiness income, but a lower 10% tax rate to dividend income, with an even lower rate provision for contiguous countries. Id.

33. See Duke, supra note 29, at 1097.

34. Id. at 1097-98.


36. Id. § 501, 50 Stat. at 830.

37. Id. The $21,600 amount approximated the amount at which the tax assessed on the basis of the progressive rate equaled the tax assessed on the basis of the flat rate. Duke, supra note 29, at 1098. The statute permitted nonresident aliens to take the same deductions and exemptions as U.S. citizens, but only to the extent that the tax liability would have exceeded the tax liability under the flat rate. Revenue Act of 1937, § 501, 50 Stat. at 830; see also Duke, supra note 29, at 1098 (nonresident aliens were allowed same deductions and exemptions as U.S. citizens subject to a minimum based on flat rate tax).

Congress later codified these provisions in the Internal Revenue Code of 1939.\(^3\)

By 1950 the number of wealthy post-war refugees in the United States who qualified as nonresident aliens made Congress uncomfortable with its capital gains exemption.\(^4\) Congress began taxing capital gains of nonresident aliens in the Revenue Act of 1950 (1950 Act)\(^41\) on the basis of how long they resided in the United States.\(^42\) For aliens present in the United States for fewer than ninety days, Congress would tax their net capital gains only if the aliens "effected" the sales or exchanges while visiting the United States.\(^43\) For aliens present for ninety days or more, Congress would apply the tax to net capital gains "effected" at any time during the tax year.\(^44\) Because Congress failed to define clearly the term "effected," the 1950 Act generated considerable litigation.\(^45\) In addition, when Congress brought capital assets into the arena of taxation, Congress subjected aliens to the government's discretionary power in characterizing all or some of their assets as capital assets.\(^46\)

The Internal Revenue Code of 1954 (1954 Code) somewhat modified capital gains criteria,\(^47\) but otherwise did not substantially alter the tax treatment of nonresident aliens and foreign corporations. The 1954 Code broadened the taxable income base of nonresident aliens by adding section 871(a)(1).\(^48\) The new section treated certain pension distributions, employee annuities, gains from the disposition of coal and timber, and gains from patent transfers as capital gains.\(^49\) The statute imposed the flat withholding tax regardless of the alien's presence in the United States at the time of the transaction.\(^50\) Nonresident foreign corporations, on the other hand, only needed to include income from the gains of timber and coal sales.\(^51\)

**B. Impact of the Foreign Investors Tax Act**

In late 1963, President Kennedy appointed a task force to investigate ways

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39. I.R.C. § 211(a)(1)(B) (1939) (applying to nonresident aliens); id. § 231(a)(1) (applying to foreign corporations).
42. Id. § 213, 64 Stat. at 936.
43. Id.
44. Id.
45. Joseph & Koppel, Foreign Investors Tax Act, 45 TAXES 113, 114 (1967); see also Weyher & Kelley, Nonresident Alien Individuals and the Capital Gains Tax, 12 INST. ON FED. TAX'N 883, 884-86 (1954) (congressional word choice intentional to encompass transactions substantially completed in the United States).
46. See, e.g., Goldsmith v. Commissioner, 143 F.2d 466 (2d Cir. 1944) (motion picture rights were capital assets).
47. I.R.C. § 871(a) (1954). The 1954 Code added items "considered to be gains from the sale or exchange of capital assets" that encompassed certain employee plan distributions and royalty payments. Id.
48. Id.
49. Id.
50. Id.
51. Id. § 881(a).
of promoting greater foreign investment in the United States.\(^{52}\) The U.S. balance of payments became negative due to massive capital exports in the 1950s and early 1960s.\(^{53}\) Congress passed the Interest Equalization Tax Act (IETA)\(^{54}\) in 1963 to discourage U.S. entities from investing in the long-term debt obligations of foreign issuers.\(^{55}\) The IETA imposed an excise tax (Interest Equalizing Tax or IET) on American portfolio investments acquiring foreign stock and debt obligations.\(^{56}\) The tax reduced the profits on the overseas investments and, thus, "equalized" the rate of return between the domestic and foreign capital markets. To avoid paying the IET, however, both U.S. and foreign companies began issuing dollar-denominated "Eurobonds."\(^{57}\)

Congress responded with a major overhaul of the tax provisions relating to nonresident aliens and foreign corporations.\(^{58}\) The resulting Foreign Investors Tax Act (FITA) of 1966 substantially revised the government's mechanisms for taxing nonresident aliens.\(^{59}\) First, the Act abolished the income level dividing line at which nonresident aliens with nonbusiness income encountered the progressive tax rates.\(^{60}\) Second, Congress increased the "presence" requirement from ninety to 183 days for U.S. source (non-business) capital gains that a nonresident alien might realize.\(^{61}\) For nonresident aliens engaged in a U.S. trade or business, FITA treated separately

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\(^{52}\) Joseph & Koppel, supra note 45, at 113. The task force described taxation of foreign investors as "one of the most immediate and productive ways to increase the flow of foreign capital to this country." TASK FORCE ON PROMOTING INCREASED FOREIGN INVESTMENT IN UNITED STATES CORPORATE SECURITIES AND INCREASED FOREIGN FINANCING FOR UNITED STATES CORPORATIONS OPERATING ABROAD, REPORT TO THE PRESIDENT 21 (Apr. 27, 1964).

\(^{53}\) Note, Repeal of the Withholding Tax on Portfolio Debt Interest Paid to Foreigners: Tax and Fiscal Policies in the Context of Eurobond Financing, 5 VA. TAX REV. 375, 380 (1985). The "balance of payments" is a system of recording all of a country's economic transactions with the rest of the world during a particular time period. The information helps a country evaluate its competitive strengths and weaknesses and forecast the strength of its currency. BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 27-28 (1985) [hereinafter BARRON'S DICTIONARY].

\(^{54}\) Interest Equalization Tax Act, ch. 41, 78 Stat. 809 (1964).

\(^{55}\) Id. preamble, 78 Stat. at 809. Congress made the Act retroactive to July 18, 1963. Id., 78 Stat. at 841 (codified at I.R.C. § 4931(e)(c) (1954)).

\(^{56}\) Id., 78 Stat. at 841 (codified at I.R.C. § 4931(d)(2) (1954)).

\(^{57}\) Note, supra note 53, at 380-81; see also Gelinas, Tax Considerations for U.S. Corporations Using Finance Subsidiaries to Borrow Funds Abroad, 7 J. CORP. TAX'N 230 (1980) (discusses specific advantages of Eurobond market). Eurobonds are bonds denominated in U.S. dollars or other currencies and sold to investors outside the country whose currency is used. The bonds are usually issued by large underwriting groups composed of banks and issuing houses from many countries. The Eurobond market is an important source of capital for multinational companies and foreign governments. BARRON'S DICTIONARY, supra note 53, at 117.


\(^{59}\) Id. The Act added § 871 to the Internal Revenue Code.

\(^{60}\) Id.; Joseph & Koppel, supra note 45, at 116. FITA therefore replaced the prior system, which prescribed different tax computation methods dependent on the taxpayer's income level, with a taxing structure that focused exclusively on the nature of the income. Id.; I.R.C. § 871 (1954).

their business and nonbusiness income.62 Previously, the system indiscriminately taxed all of the alien's income at the graduated tax rates once the system had classified the alien as a recipient of business income.63 As a result of FITA, the nonresident alien only had to subject that part of his income "effectively connected" with a U.S. trade or business to the harsher progressive rates.64

To determine whether income constituted "effectively connected" U.S. business income, FITA looked to whether U.S. trade or business activities played a material role in the realization of the income or gain, and whether the nonresident alien had an office or other fixed place of business within the United States to which the government could attribute the income.65 Under the "fixed place of business" test, the Internal Revenue Service (IRS) could treat even certain foreign income of such an alien as effectively connected United States income.66 The amendment to section 861 of the Code in FITA seemed to work against the government's objective of stimulating foreign investment.67 The amendment abolished the former tax exemption for interest income that nonresident aliens and foreign corporations not engaged in business in the United States earned on their bank deposits.68 Prior to FITA, interest income of this nature qualified as foreign source income.69 FITA repealed this status.70

Although FITA included no major tax changes with regard to nonresident foreign corporations, resident foreign corporations received the same treatment as resident aliens—a flat withholding tax on U.S. income not effectively connected with the conduct of trade or business.71 The statute also revised the source-of-income definitions pertaining to the payment of interest and dividends by foreign corporations.72 The changes reduced the probability that the recipient of interest or dividends paid by a foreign corpo-

62. Id. § 871(b); Joseph & Koppel, supra note 45, at 117-18.
63. Joseph & Koppel, supra note 45, at 117.
64. FITA § 102(d), 80 Stat. at 1542. The section added § 864(c) to the Code.
65. I.R.C. § 864(c)(2) (1954); Treas. Reg. § 1.864-4(c) (1972). The Code and the regulations applied two tests for determining what income fell within the definition of effectively connected with a trade or business: (1) effective connection existed if taxpayer derived income in question from assets that the producer of the income used in a trade or business in the United States; (2) effective connection existed if trade or business activities in the United States materially generated the income in question. Id.; A. RADO, TAXATION OF FOREIGN INVESTORS IN THE UNITED STATES 11-12 (1975).
67. FITA § 102(a)(1)(B), 80 Stat. at 1543. Two commentators observed:
As foreign depositors cannot be expected to keep abreast of all the vagaries of the American tax law, the tentative elimination of the exemption may well cause them to close out their American accounts. It will also discourage potential new depositors. Under the circumstances, it would have been wiser for Congress to let the exemption stand undisturbed at least for the time being.
Joseph & Koppel, supra note 45, at 124.
68. FITA § 102(a)(1)(B), 80 Stat. at 1541.
70. FITA § 102(a)(1)(B), 80 Stat. at 1541.
71. Id. § 104(a), (b), 80 Stat. at 1555 (codified as amended at I.R.C. §§ 881-882 (1954)).
72. Id. § 102(a)(2), (b), 80 Stat. at 1541, 1543 (interest and dividends respectively; codified as amended at I.R.C. § 861 (1954)).
ration with its U.S. earnings would have to treat such interest or dividends as U.S. source income.\footnote{73} FITA required income tax withholding for both nonresident aliens\footnote{74} and foreign corporations\footnote{75} based on all fixed or determinable annual or periodic income not effectively connected with the operation of a U.S. trade or business. FITA continued to apply the standard withholding rate of thirty percent to capital gains should the nonresident alien meet the test for taxability.\footnote{76} The new withholding rules reflected the change in the congressional policy of segregating nonbusiness income from business income.\footnote{77}

During the late 1960s, an increase in international tax treaties created lower withholding rates on foreign investment income.\footnote{78} As a consequence of these treaties, U.S. tax revenue from foreign entities pursuant to the withholding statute declined significantly.\footnote{79} The decline eventually stopped and the balance of payments stabilized in 1973.\footnote{80} The government then eased the controls on capital outflows and allowed the IET to expire in mid-1974.\footnote{81}

In 1980 Congress passed the Foreign Investment in Real Property Tax Act (FIRPTA).\footnote{82} The statute subjected a foreign person's transfer of a U.S. real property interest to a withholding tax.\footnote{83} FIRPTA required buyers of the property to withhold ten percent of the contract price and remit the funds to the government within twenty days.\footnote{84}

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)\footnote{85} included provisions to begin withholding on interest and dividend payments

\footnote{73} Joseph & Koppel, supra note 45, at 123. "[G]enerally only dividends or interest paid by foreign corporations engaged in trade or business in the United States can be treated as U.S. income." \textit{Id.}

\footnote{74} FITA § 103(h), 80 Stat. at 1553 (codified as amended at I.R.C. § 1441 (1954)).

\footnote{75} \textit{Id.} § 104(c), 80 Stat. at 1557 (codified as amended at I.R.C. § 1442 (1954)).

\footnote{76} \textit{Id.} § 103(a)(1), 80 Stat. at 1547 (codified as amended at I.R.C. § 871 (1954)).

\footnote{77} See A. RADO, supra note 65, at 7. As another phase of the government's attempt to stem the tide of capital out-flow, the Commerce Department's Office of Foreign Direct Investments issued regulations in 1968 that required U.S. multinational corporations to fund their foreign operations by raising capital abroad instead of exporting dollars. The regulations had a major impact on the growth of the Eurobond market. Between 1965 and 1973, U.S. companies raised about ten billion dollars in the Eurobond market (an average of 30% of the total new issue volume). U.S. companies continued to raise capital abroad even after the balance of payments returned to a surplus. Note, supra note 53, at 381 (citing Newburg, \textit{Financing in the Euromarket by U.S. Companies: A Survey of the Legal and Regulatory Framework}, 33 BUS. LAW. 2171, 2171 (1978)).

\footnote{78} Lewis, \textit{America's Reliance on Foreign Funds to Fight the Deficit: Repeal of the 30% Withholding Tax}, 12 BROOKLYN J. INT'L L. 127, 136 (1986).

\footnote{79} \textit{Id.} at 128.

\footnote{80} Note, supra note 53, at 382.

\footnote{81} \textit{Id.}


\footnote{83} FIRPTA § 1122(a), 94 Stat. at 2682 (codified as amended at I.R.C. § 891 (1954)).

\footnote{84} \textit{Id.}

from most corporations. The statute, however, continued to apply preexisting withholding requirements for nonresident aliens and foreign corporations. TEFRA also required excise taxes on bearer bonds that failed to comply with specific registration requirements. TEFRA's withholding and registration provisions reflected Congress's desire to achieve greater compliance with the reporting of interest income. Soon, however, Congress found itself seriously reexamining its objectives.

II. FOREIGN TAX POLICY FOR THE 1980S

A. Repeal of the Withholding Tax on Portfolio Interest

In the early half of 1984, U.S. corporations could use either of two sanctioned loopholes to avoid the thirty percent withholding tax imposed on interest payments to nonresident aliens and foreign corporations. First, if a company's domestic subsidiary derived less than twenty percent of its gross income from U.S. sources, the Internal Revenue Code (Code) required no withholding tax on bonds issued by the subsidiary. The major drawback to using this loophole was the requirement that the company have a domestic finance subsidiary, which most U.S. parent companies did not have. Second, tax treaties provided a mechanism for avoiding the tax withholding requirements on interest payments. The Code imposed no withholding obligations on bonds issued by a foreign finance subsidiary. Making use of the government's statutory latitude, U.S. corporations avoided tax withholding by setting up some 25,000 "paper" subsidiaries under a favorable tax treaty with the Netherlands Antilles. The treaty arrangement enabled the financing subsidiaries to borrow from European investors and to secure these loans with Eurobonds without having to withhold any tax. The subsidiaries, in turn, loaned the proceeds to their parent companies in the United States.

86. TEFRA § 301, 96 Stat. at 595-97 (codified as amended at I.R.C. §§ 3451-3456 (1954)).
87. Id.
88. Id.
90. I.R.C. §§ 861(a)(1)(B), 1441(a), 1442(a) (1954). Sections 1441 and 1442 require withholding on U.S. source income, but § 861(a)(1)(B) treats interest paid to nonresident aliens and foreign corporations as foreign source income if the interest came from a subsidiary satisfying the test of 20% or less U.S. income.
92. Id. at 385 n.78. "Incorporation of the [subsidiary] in a foreign jurisdiction provided a means of avoiding U.S. withholding on interest paid by the [subsidiary] to the foreign bondholders." Id. Interest payments that a U.S. company made to a foreign subsidiary constituted U.S. source income, requiring a treaty to provide exemption from the withholding requirements. Id.
93. Recent Development—Tax Reform Act of 1984—Netherlands Antilles—Effect of the Repeal of the Withholding Tax on Portfolio Interest Payments to Foreign Investors, 15 GA. J. INT'L & COMP. L. 111, 112 (1985). The Netherlands Antilles consist of two small island groups in the Caribbean Sea with a land area approximately one-third the size of Rhode Island and a population of about 245,000. Id. at 112 n.7.
94. Id. at 112. The U.S. corporations' financing subsidiaries in the Antilles increased their borrowing from $1 billion to $16 billion in 1982 alone. Id. at 112 n.12.
95. Id. at 112.
The U.S. companies reduced their financing costs because the European investors were willing to accept lower interest rates on the "tax free" Eurobonds.96

The utility of the Netherlands Antilles treaty as a device to circumvent tax withholding diminished with the passage of the Tax Reform Act of 1984 (TRA of 1984).97 Section 127 of the Act repealed the thirty percent withholding tax imposed on "portfolio interest" that nonresident aliens and foreign corporations earned.98 Supporters of the legislation argued that tax treaties had already substantially weakened the value of the thirty percent withholding tax.99 In addition, they argued that the repeal of the tax would bring about a broader credit market that would, in turn, stimulate the U.S. economy and help fight the government deficit with lower interest rates.100 Opponents contended the repeal would increase U.S. reliance on foreign funds and make the country more vulnerable to the erratic turns of international events.101 Congress concluded that direct access to the Eurobond market for U.S. corporations coupled with the inflow of foreign investment justified the risk of possible economic uncertainty.102 Congress also hoped to ease the government's impact on the supply of funds available to U.S. borrowers.103

In 1984, the Treasury Department issued $35 billion in long-term bonds.104 The volume of the Treasury’s borrowing, along with its reputation for providing secure investments, put domestic corporations at a major disadvantage. The Treasury, however, did not compete in the Eurobond market since TEFRA, which Congress enacted in 1982, required the Treasury to issue all debt in registered form.105 As a result, foreign investors, wishing to retain their anonymity, directed their funds to the unregistered Eurobond market.106 U.S. corporations thus saw the Eurobond market as the most practical source of capital.107 By repealing the thirty percent withholding tax, Congress hoped to lure foreign investors away from the Eurobond mar-

96. J. GRABBE, INTERNATIONAL FINANCIAL MARKETS 273 (1986). Borrowers raising capital through Eurobonds generally issue the instruments as "bearer" bonds. Proof of ownership of bearer bonds consists of the possession of the bonds, and not the registration of the bond under the name of a specific individual. The anonymity of the bond owner makes taxation possible only through withholding. Eurobonds, however, contain covenants that require the debtor to increase interest payments to compensate for any tax withheld. Id.
99. Lewis, supra note 78, at 128.
100. Id.
101. Id. at 131.
102. See Note, supra note 53, at 393.
103. See id.
104. Lewis, supra note 78, at 141.
105. TEFRA § 310(b), 96 Stat. at 595.
106. See supra note 96.
107. Lewis, supra note 78, at 134-36.
ket and into the domestic bond market, easing the competition between the government and private business.\textsuperscript{108}

Congress recognized that repealing the withholding requirements on bearer bonds would tempt U.S. investors to masquerade as foreigners and purchase the bonds overseas, thereby evading U.S. tax liability.\textsuperscript{109} To deal with the potential compliance problem, Congress granted the Treasury discretion to issue regulations defining which portfolio interest obligations would satisfy the criteria for repeal of the withholding tax.\textsuperscript{110} Prior to the TRA of 1984, TEFRA added section 163(f) to the Code.\textsuperscript{111} Section 163(f) denied interest deductions to the issuers of "registration-required" bearer bonds that failed to satisfy the specific provisions of section 163(f)(2)(B).\textsuperscript{112} Treasury Decision 7965 essentially incorporated section 163(f)'s registration-required obligation definition.\textsuperscript{113} The decision set forth three tests to determine if the portfolio interest obligations qualified for the repeal. First, the standard looked to the "arrangements" to see if their design reasonably ensured that the obligations would be issued only to foreign persons.\textsuperscript{114} Second, the repeal only applied to interest payable outside the United States.\textsuperscript{115} Third, the provision required the obligations to bear a statement warning U.S. holders of their tax liability.\textsuperscript{116}

In addition to defining the standards for portfolio interest, the IRS issued Treasury Decision 7967 to sort out the conflicting requirements of TEFRA's "backup withholding" rules in light of the repeal of the thirty percent tax withholding requirements.\textsuperscript{117} The Treasury explained that the backup withholding provisions applied only if the issuer of the bond or other investment had actual knowledge that the payee was a U.S. person.\textsuperscript{118} Additionally, Treasury Decision 7965 stated that the IRS would deny interest deductions to any issuer who did not take measures reasonably designed to ensure that

\begin{itemize}
  \item \textsuperscript{108} See id. at 136.
  \item \textsuperscript{109} See Recent Development, supra note 93, at 120.
  \item \textsuperscript{110} I.R.C. § 163(f)(2)(c) (1954), as amended by TEFRA in 1982. The Secretary of the Treasury determines if the exchange of information between the United States and a foreign country suffices to prevent U.S. citizens from evading U.S. income tax. If the Secretary finds the exchange of information insufficient, the Secretary may declare, through a published statement, that the provisions of this subsection (repeal of the withholding tax) shall not apply. Id. § 871(h)(5).
  \item \textsuperscript{111} Id. § 163(f)(2)(B) requires that:
    \begin{enumerate}
      \item there are arrangements reasonably designed to ensure that such obligations will be sold only to a person who is not a United States citizen;
      \item interest [on nonregistered obligations] is payable only outside the United States and its possessions; and
      \item on the face of such obligation there is a statement that any United States person who holds such obligation will be subject to limitations under the United States income tax laws.
    \end{enumerate}
  \item \textsuperscript{112} Id. § 163(f).
  \item \textsuperscript{113} T.D. 7965, 1984-2 C.B. 38.
  \item \textsuperscript{114} Id.
  \item \textsuperscript{115} Id.
  \item \textsuperscript{116} Id.
  \item \textsuperscript{117} T.D. 7967, 1984-2 C.B. 329. TEFRA added to the Code § 3451, which imposed, with various exceptions, a 10% withholding requirement on interest and dividend payments. TEFRA § 301, 96 Stat. at 576.
  \item \textsuperscript{118} T.D. 7967, 1984-2 C.B. at 331.
\end{itemize}
nonresident aliens or their agents, and not U.S. citizens or their agents, purchased the bonds.\textsuperscript{119} The Treasury Department issued a number of other decisions and rulings relating to portfolio interest.\textsuperscript{120} Overall, the Treasury's stringent interpretation of the statute raised some question as to whether dealing with foreign subsidiaries might still prove simpler than attempting to comply with the complex government guidelines associated with the repeal of the thirty percent withholding tax.

\textbf{B. Tax Reform Act of 1986: The Branch Profits Tax and the Branch Level Interest Tax}

Although the Tax Reform Act of 1984 purportedly repealed the thirty percent withholding tax on portfolio interest, the withholding provisions remained intact with regard to other interest and investment income.\textsuperscript{121} Despite the substantial changes generated by the Tax Reform Act of 1984, Congress's international tax policy underwent major reform with the Tax Reform Act of 1986 (TRA of 1986).\textsuperscript{122} Congress turned its attention to the flow of capital between business operations based in the United States and the foreign corporations that controlled them. The foreign corporations avoided creating U.S. subsidiaries because distributions from these subsidiaries to their parent corporations would constitute dividends subject to the thirty percent withholding tax.\textsuperscript{123} Instead, foreign corporations conducted business in the United States through "branch" offices.\textsuperscript{124} Based on the theory that the branch and the foreign headquarters formed parts of the same organization, capital going from one to the other simply moved within the same entity.\textsuperscript{125} Prior to the TRA of 1986, section 861 of the Code set the standard for taxation of corporate distributions.\textsuperscript{126} A foreign corporation

\begin{footnotesize}
\textsuperscript{119} 1984-2 C.B. at 45.
\textsuperscript{120} See, e.g., T.D. 8046, 1985-2 C.B. 61 (imposing sanctions on issuers of debt obligations for failure to comply with registration requirements); T.D. 7972, 1984-2 C.B. 327 (applying backup withholding rules to payments by foreign offices of U.S. brokers).
\textsuperscript{121} H.R. 4170, 98th Cong., 2d Sess. (1985).
\textsuperscript{122} Pub. L. No. 99-514, 100 Stat. 2085 [hereinafter TRA of 1986 or the 1986 Act].
\textsuperscript{124} See id. Not all tax analysts agreed with the view that tax savings motivated foreign corporations' use of branch offices in the United States. A major accounting firm posed the argument that:
\begin{quote}
The basic reason for choosing a branch vs. subsidiary form for conducting bank operations in the U.S. is the need to base the lending limits of the U.S. operation on the bank's worldwide capital or equity base. Current law precludes any foreign corporation from capitalizing its branch with debt versus equity thereby eliminating a perceived advantage of operating in the U.S. through a branch rather than a subsidiary.
\end{quote}
Letter from Washington D.C. office of Peat, Marwick, Mitchell & Co. to Mr. J. Roger Mentz, Deputy Assistant Secretary of the Treasury (June 27, 1986) (opposing pending legislation).
\textsuperscript{125} Jacobson, supra note 123, at 341.
\end{footnotesize}
with U.S. business operations that paid interest or dividends to nonresident aliens or foreign corporations generally triggered U.S. tax liability only if fifty percent or more of the foreign corporation's worldwide gross income for the three prior years originated in the United States. Congress eliminated the fifty percent U.S. income test with the TRA of 1986 and replaced it with new Code section 884. Section 884 imposes two similar but distinct mechanisms for taxing the flow of capital from a foreign corporation's U.S.-based business operations.

The key taxing device, labelled the "Branch Profits Tax" (BPT), treats the U.S. branch of a foreign corporation as a separate entity. Although both prior and current law tax that part of a foreign corporation's income effectively connected with the conduct of a trade of business in the United States, foreign corporations generally avoided tax on the distribution of profits by either characterizing the payment as an intra-company transfer or by staying under the fifty percent line of demarcation. U.S. corporations' earnings, on the other hand, faced taxation both at the corporate level and at the shareholder level upon distribution in the form of dividends. Congress saw a disparity between the potential double taxation of domestic corporations' profits and the absence of taxation when foreign corporations' U.S. branches repatriated their earnings. In an effort to equalize the treatment of foreign and domestic corporations, the new section 884 creates a "dividend equivalent amount" for foreign corporations. Rather than tax

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129. Section 884, titled "Branch Profits Tax," imposes a 30% tax on a foreign corporation's dividend equivalent amount under § 884(a), and a similar tax on interest allocable to effectively connected income under § 884(f). Id. § 884(a), (f).

130. Viewing the foreign corporation's U.S. branch operation as a separate entity provides a basis for taxing the theoretical distribution of earnings from the branch entity to the foreign parent corporation. See General Explanation, supra note 127, at 1036 (foreign corporations with U.S. branches managed to avoid nearly all liability for withholding taxes).

131. See supra note 65.

132. See supra note 130 and accompanying text.

133. I.R.C. §§ 301, 316 (1986). Section 301 in conjunction with § 316 defines and determines the taxability of corporate distributions to shareholders. See id.


135. I.R.C. § 884(b) (1986). An international tax periodical illustrates the impact of this mechanism purportedly designed to put domestic and foreign corporations on an equal footing:

Suppose a foreign corporation engages in a United States trade or business during 1988 which generates $500,000 of pre-tax earnings and profits, which is equal to its taxable income. During 1988, the branch remits its current earnings reduced by reserves for applicable taxes to its home office. The normal corporate income tax on its 1988 taxable income is 34% of $500,000, or $170,000. Ignoring the effect of any tax treaty, the branch profits tax would be 30% of [the remaining] $330,000 . . . or $99,000. The foreign corporation's total [tax] liability is then $170,000 plus $99,000, or $269,000. The effective tax rate on the foreign corporation's earnings is 53.8%. 
the shareholders of the corporation, the BPT imposes a thirty percent tax (subject to treaty modification) on the foreign corporation itself.\textsuperscript{136} In theory, the withdrawal of earnings from a foreign corporation's U.S. branch for use as a dividend payment or investment in another country should trigger the tax.\textsuperscript{137} Tracing actual distributions, however, poses significant problems in practice.\textsuperscript{138} Section 884 uses an alternative measure designed to approximate the amount of withdrawals from the foreign corporation's U.S. operations.\textsuperscript{139}

The foreign corporation's dividend equivalent amount consists of the branch's effectively connected U.S. "earnings and profits" (E&P) for the tax year, adjusted for changes in the entity's "U.S. net equity."\textsuperscript{140} To arrive at the amount of effectively connected U.S. E&P, the statute requires the foreign corporation first to isolate income and expense items associated with the operation of its fictional U.S. subsidiary.\textsuperscript{141} Next, the foreign corporation must adjust the income and expense amounts in accordance with section 312, applying that section in the same manner as a domestic corporation would in calculating E&P.\textsuperscript{142} Section 884(b) then imposes an increase or decrease on the amount of effectively connected E&P on the basis of that

\begin{thebibliography}{10}
\item Nauheim & Jacobson, \textit{supra} note 134, at 466 n.9.
\item I.R.C. § 884(a) (1986). Congress noted the ease of administration as one of the virtues of the BPT. \textit{General Explanation, supra} note 127, at 1037. The concept of a BPT did not, however, originate with the 1986 Act. A similar tax system currently exists in Brazil, Canada, Mexico, France, Venezuela, and several other countries. \textit{See International Tax Notes—Foreign Corporate Income and Withholding Tax Rates, 11 Int'l Tax J. 243, 243-48 (1985); see also Block & Walker, Taxation: International Evidence, in \textit{TAXATION AN INTERNATIONAL PERSPECTIVE} 3 (1984) (synopsis of tax mechanisms of various foreign countries).}
\item Blessing, \textit{The Branch Tax}, 40 Tax Law. 587, 590 (1987). Certain deemed transfers of earnings from the U.S. branch actually trigger the tax, without regard to distributions from the foreign corporation to its shareholders. Although generally referred to as a "branch profits" tax, the BPT more closely resembles a "branch profits remittance" tax since it approximates a dividend tax. \textit{Id.}
\item Id. at 589.
\item Id. § 884(b) (1986).
\item Id. § 884(b)-(d). Although fundamental to the calculation of taxation on corporate distributions, the Code does not provide an explicit definition of "earnings and profits." \textit{See B. Bittker & J. Eustice, FUNDAMENTALS OF FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS} ¶ 7.03 (1987) (overview of historical development and current application of earnings and profits concept). Section 884(d) provides a rather circular definition in its application of the phrase to the branch profits tax: "effectively connected earnings and profits" means earnings and profits (without diminution by reason of any distributions made during the taxable year) which are attributable to income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States." I.R.C. § 884(d)(1) (1986). Section 884(d)(2) identifies some income sources that do not constitute effectively connected earnings and profits, such as income from ships or aircraft (exempt under § 883(a)), certain foreign sales corporation income (described in §§ 921(d) and 926(b)), gains from the sale of real property (subject to FIRPTA), and some insurance corporation income (pursuant to § 953(c)(3)(C)). \textit{Id.} § 884(d)(2); \textit{see also Blessing, supra} note 137, at 594-98 (detailed illustration of "U.S. net equity" computation).
\item Id. § 884(c)(2)(C) (1986).
\item Id. §§ 312(a), 884(d). Section 312 does not apply identically to domestic corporations and § 884. Under § 312(a), dividend distributions reduce E&P for domestic corporations, but § 884(d) prohibits that adjustment for corporations computing the BPT. Feingold & Rozen, \textit{New Regime of Branch Level Taxation Now Imposed on Certain Foreign Corporations}, 66 J. Tax'n 2, 3 (1987).
\end{thebibliography}
year's change in U.S. net equity.\textsuperscript{143} Congress mandated that an increase in U.S. net equity should reduce the effectively connected E&P amount on the theory that the increase came about as the corporation reinvested funds that the corporation otherwise would have distributed.\textsuperscript{144} Conversely, a decrease in U.S. net equity increases the effectively connected E&P since the reduction implies the branch repatriated earnings during the year, and these earnings should not escape the tax.\textsuperscript{145} The dividend equivalent amount emerges as the final product of this series of computations.\textsuperscript{146} Section 884(a) assesses the thirty percent BPT on the dividend equivalent amount.\textsuperscript{147}

Section 884(c) defines U.S. net equity as U.S. assets reduced by U.S. liabilities.\textsuperscript{148} The legislative history emphasizes that the terms include only those assets that generate taxable income in the United States and those liabilities that generate expenses allocable to that income.\textsuperscript{149} Therefore, a section 884(c) computation would not include assets that produce income that treaty provisions would protect.\textsuperscript{150}

The other major taxing mechanism that the TRA of 1986 implemented to tax foreign corporations' income employs a system analogous to the BPT.\textsuperscript{151} The Branch-Level Interest Tax (BLIT)\textsuperscript{152} reflects Congress's awareness that a foreign corporation could reduce its U.S. branch's profits if that corporation capitalized the branch with interest-bearing debt instead of equity.\textsuperscript{153} To discourage this maneuver, section 884(f) states that the BLIT will treat interest paid by a foreign corporation's branch engaged in a trade or business in the United States as if paid by a domestic corporation to a parent foreign corporation.\textsuperscript{154} Defining the interest as U.S. source interest in this way enables the government to impose the standard thirty percent withholding tax (subject to modification by treaty) on that foreign branch.\textsuperscript{155} Portfolio inter-

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{143} I.R.C. § 884(b)(1), (2) (1986).
\item \textsuperscript{144} \textit{GENERAL EXPLANATION}, \textit{supra} note 127, at 1039.
\item \textsuperscript{145} \textit{Id}.
\item \textsuperscript{146} I.R.C. § 884(b) (1986).
\item \textsuperscript{147} \textit{Id.} § 884(a). The Internal Revenue Service (IRS) provided for some exceptions to the branch profits tax in Notice 86-17. The government said that under forthcoming regulations, the IRS will generally not impose the BPT on: "(1) the complete termination of a foreign corporation's United States trade or business, (2) certain liquidations or reorganizations of a foreign corporation that has conducted a U.S. trade or business, or (3) a section 351 tax-free incorporation of a foreign corporation's U.S. trade or business." I.R.S. Notice 86-17, 1986-2 C.B. 379.
\item \textsuperscript{148} I.R.C. § 884(c)(1)(A), (B) (1986).
\item \textsuperscript{149} \textit{GENERAL EXPLANATION}, \textit{supra} note 127, at 1040.
\item \textsuperscript{150} \textit{Id}.
\item \textsuperscript{151} I.R.C. § 884(f) (1986); see Feingold & Rozen, \textit{supra} note 142, at 5-6 (explains application of I.R.C. § 884(f) and speculates on possible interpretations of ambiguities).
\item \textsuperscript{152} I.R.C. § 884(f) (1986). The Code does not apply the phrase "Branch-level interest tax," but the Joint Committee Report uses this terminology in its explanation of the tax. \textit{GENERAL EXPLANATION}, \textit{supra} note 127, at 1041-42.
\item \textsuperscript{154} I.R.C. § 884(f)(1)(A) (1986).
\item \textsuperscript{155} \textit{Id.} § 884(f)(1)(B). Section 884(f)(1)(B) cross references § 881(a), which imposes the 30% withholding tax. \textit{Id.} §§ 884(f)(1)(B), 881(a).
\end{enumerate}
\end{footnotesize}
est, interest on bank deposits, and other interest sources not effectively connected with a U.S. trade or business remain exempt from taxation.156

As an attempt to maintain a balance between interest income subject to U.S. tax and interest deductions reducing U.S. tax, Congress devised a fictitious loan system similar to the hypothetical dividend procedure of the BPT.157 Section 1.882-5 of the Treasury Regulations158 provides alternative methods for determining the interest deductions allowable against a foreign corporation's effectively connected U.S. income.159 If this amount exceeds the actual interest that the branch paid, section 884(f)(1)(B) treats the excess as interest on a loan from a parent foreign corporation to its U.S. subsidiary.160 The interest paid on the abstract loan also falls under the withholding provisions.161

When imposing either the BPT or the BLIT, section 884(e) of the Code takes into account tax treaty provisions between the U.S. and foreign countries.162 Section 884(e)(1) states that the BPT applies regardless of any tax treaty unless: (1) the foreign corporation satisfies the definition of a "qualified resident" in a treaty country that prohibits the BPT,163 or (2) the tax treaty of the country where the foreign corporation resides provides for a second-tier withholding tax on dividends that the foreign corporation paid.164 The statute imposes the residency requirement to deter the shareholders of foreign corporations from "treaty shopping."165 The qualified resident test generally precludes a foreign corporation from achieving the

156. See, e.g., id. §§ 871, 881. Current exemptions from the withholding requirement include: (1) interest from bank and savings and loan deposits and amounts held by insurance companies, id. §§ 871(i)(2)(A), (i)(3), 881(d), 1441(c)(10), 1442; (2) interest paid on obligations effectively connected with a United States trade or business, Treas. Reg. § 1.1441-4(a) (as amended in 1985); (3) original issue discount on obligations with maturity period of 183 days or less, I.R.C. § 871(g)(1)(B)(i) (1986); (4) portfolio interest, id. § 881(c).
157. I.R.C. § 884(f) (1986); Blessing, supra note 137, at 592.
159. Id. The regulation provides a three-step process for determining the interest deduction allowed to a foreign corporation with respect to its effectively connected gross income. In step one the corporation values all assets (in U.S. dollars) connected with the U.S. trade or business during the year. In step two the corporation multiplies the amount arrived at in step one by either a fixed ratio (95% for banks, 50% for other businesses) or the actual ratio of the corporation's world-wide liabilities over its world-wide assets for the year. In step three the entity applies the amount arrived at in step two to either the branch book/dollar pool method or the separate currency pool method to arrive at the deductible interest. The corporation may change methods without obtaining the consent of the Commissioner. Id.
161. GENERAL EXPLANATION, supra note 127, at 1041.
162. I.R.C. § 884(e) (1986); see also INTERNAL REVENUE SERVICE, WITHHOLDING OF TAX ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS, PUBLICATION 515 (1987) [hereinafter PUBLICATION 515] (providing a country-by-country table summary of withholding rates based on treaty provisions).
164. Id. § 884(e)(1)(B).
165. Treaty shopping involves an attempt by nonresident investors who control foreign corporations to attain the benefits of favorable treaty provisions (such as reduced withholding rates) through the use of only superficial commitments to the country holding the treaty with the United States. If a foreign corporation with a U.S. branch satisfies the requirements for a "qualified resident" of the treaty country, then, by definition, the corporation is not treaty shopping. GENERAL EXPLANATION, supra note 127, at 1043-45.
section 884(e) treaty-override if U.S. citizens, or resident aliens, or individuals who are not residents of the treaty country own more than fifty percent of the corporation's stock (based on value). A foreign corporation may also fail the qualified resident test if fifty percent or more of its income goes to satisfy debts owed to U.S. citizens or resident aliens or to persons who are not residents of the treaty country.

If the tax treaty with a foreign country prohibits the BPT but permits a second-tier dividend withholding tax, then, absent treaty shopping, the withholding tax rather than the BPT applies. Congress also amended the section 861(a)(2)(B) threshold for imposing the withholding obligation. If the branch's U.S. business income exceeds twenty-five percent of the foreign corporation's total income, then the statute requires withholding on dividend distributions. The United States, however, honors tax treaties that prohibit both the second-tier withholding tax and the BPT, if the foreign corporation does not engage in treaty shopping.

Section 884(f)(1), dealing with the BLIT, makes a one-sentence cross-reference to the treaty directives of section 884(e). The joint committee report, however, states that the BLIT applies despite treaty provisions to the contrary if either the interest payor or the recipient treaty shops. Absent treaty shopping, the BLIT does not override the treaty between the United

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166. I.R.C. § 884(e)(4)(A)(i) (1986). The Joint Committee Report states that the Act determines stock ownership by “looking through corporations, partnerships, estates, and trusts to ultimate individual ownership.” GENERAL EXPLANATION, supra note 127, at 1043. Section 318 provides detailed constructive stock ownership attribution rules for various Code sections; neither § 884 nor the Joint Committee Report, however, provide guidance as to how the qualified resident test will determine constructive stock ownership. See I.R.C. § 318(a) (1986).

167. I.R.C. § 884(e)(4)(A)(ii) (1986). The provision prevents the erosion of the tax base to which the treaty country applies its tax, so that nonresidents do not benefit from the treaty while substantially avoiding the treaty country's regular tax. Blessing, supra note 137, at 615.

168. I.R.C. § 884(e)(3)(B) (1986). Treaties with eight countries fall within this category: Denmark, Egypt, Finland, Norway, the Philippines, South Korea, Sweden, and Switzerland. Blessing, supra note 137, at 620.


170. Id. Treaties with several countries satisfy this test including Belgium, Iceland, Japan, the People's Republic of China, and the United Kingdom. Blessing, supra note 137, at 622. Congress previously set the threshold at 50%. TRA of 1986, Pub. L. No. 99-514, § 1214(b), 100 Stat. 2085, 2542.


172. Id. § 884(f)(1). "Rules similar to the rules of subsection (e)(3)(B) shall apply to interest described in the preceding sentence." Id.

173. GENERAL EXPLANATION, supra note 127, at 1044-45. The Joint Committee Report provides an example of the statute's application. Assuming that a foreign corporation with a U.S. branch claims a U.S. interest deduction of $100 in a taxable year, the illustration shows $80 of that amount as paid by the branch to an unrelated, second foreign corporation, and $20 allocated under Treas. Reg. § 1.882-5. See supra note 159. The initial foreign corporation's country has a treaty with the United States that precludes the United States from imposing tax on interest paid by residents of that country (country Y). The second foreign corporation's country (country Y) precludes the United States from imposing tax on interest paid to residents of country Y. Applying BLIT, the United States imposes no withholding on the $80 of interest paid by the U.S. branch if the branch does not treaty shop. The withholding applies only if both corporations treaty shop. As for the $20 of excess interest, the United States imposes the 30% withholding tax if only the first corporation treaty shops. GENERAL EXPLANATION, supra note 127, at 1045.
States and the foreign corporation's home country.174

III. TAX STRATEGY FOR THE INTERNATIONAL CAPITAL MARKET GAME

A. The Economic Impact of Foreign Investment in the United States

The federal government’s taxing power extends to the worldwide income of U.S. citizens, resident aliens, and domestic corporations.175 Nonresident aliens and foreign corporations, however, expose themselves to U.S. tax liability when they generate or receive qualified income.176 The foreign entities submit voluntarily to taxation in exchange for the opportunity either to make portfolio investments or generate income through direct business activity. Foreign investment and business capital inflows reached unprecedented levels during the 1980s.177 Congress's international tax policy provides a means to regulate the extent of foreign investment within the United States. United States citizens seem to harbor an inherent distaste for the idea of foreign control of U.S. property.178 Although foreign capital interests in the United States may have reached a stage where they threaten our sense of autonomy, a rational response requires an examination of both the virtues and the vices of foreign funds in the United States.

The saving habits of U.S. citizens fall well below the standards of other industrialized countries.179 This disposition towards minimal savings creates a limited domestic capital pool for both business and government borrowing. The current administration's domestic tax policy focuses on reducing individual and corporate tax rates to stimulate the economy through increased spending and business expansion.180 While this plan helps to stimulate the economy, government spending continues to rise.181 Congress faces the task of finding a means to finance a massive federal deficit without generating inflation or high interest rates. Foreign capital provides a tempting, but deceptive, sense of security.

175. See I.R.C. § 1 (1986) (tax imposed on individuals); id. § 11 (tax imposed on corporations); id. § 7701(b) (defining resident alien); id. § 61 (defining gross income).
176. See id. § 872 (defining gross income of nonresident alien individuals); id. §§ 881, 882 (1986) (imposing tax on foreign corporations based on business or nonbusiness income).
177. See supra text accompanying notes 1, 2.
178. See, e.g., John Bryant, Putting America First: Confronting Growing Foreign Ownership of America (Town Hall meeting topics, Dallas, Texas, Mar. 26 & 27, 1988) (advocating passage of a “Disclosure Amendment” to report large foreign acquisitions).
179. Kahley, supra note 2, at 38.
Reliance upon foreign capital places the government at the mercy of whatever factors may influence foreign investors. Portfolio interest investments tend to be highly liquid. Billions of dollars of foreign capital move in and out of the country in a fraction of a second with the use of electronic transfer systems. Over-dependence on foreign capital creates a scenario similar to the energy policy of the mid-1970s. At that time the U.S. economy suffered serious repercussions when it failed to prepare for reduced oil supplies and higher energy costs. Although foreign capital, unlike OPEC-controlled oil, reaches the United States from a vast variety of sources, the government's reliance on this source of funds places the economy in a similarly precarious position.

Foreign capital plays a far less significant role with U.S. businesses than it does with government debt. Domestic lending institutions provide an adequate source of capital for business expansion and development. Unlike the government debt, the interest payment of which the government struggles to cover, domestic business loans stimulate the economy by providing initial operating funds for new enterprises. The cycle of borrowed capital, business creation, profitable operations, and repayment of debt serves as a self-perpetuating phenomenon. Government debt, in contrast, does little more than burden the economy.

B. Conflicting Policy Approaches of the 1984 and 1986 Tax Reform Acts

Congress's tax exemption for foreign portfolio interest under the TRA of 1984 contrasts sharply with its creation of the BPT and BLIT under the TRA of 1986. In the TRA of 1984 Congress attempts to attract passive foreign investment by providing exemption from U.S. taxation. In contrast, the government, under the TRA of 1986, imposes a substantial and complex surtax on foreign business investments in the United States. These divergent approaches seem especially peculiar in comparison to Congress's treatment of the domestic counterparts of these two income sources.

The TRA of 1986 imposes highly restrictive controls and limits on most passive investment income to prevent the tax advantages of loss recognition. In addition, Congress reduces, and in some cases eliminates, the tax...
advantages of the savings-oriented Individual Retirement Account (IRA) for taxpayers currently participating in an employer-sponsored qualified plan.\textsuperscript{188}

Foreign investors, in contrast, continue to reap the benefits of tax-free portfolio interest income.\textsuperscript{189}

Although the TRA of 1986 reduces deductions previously available to offset business income, it also cuts general tax rates so that domestic corporations incur no significant increase in tax liability.\textsuperscript{190} The changes, however, reflect a shift in domestic tax policy since all prior tax legislation in the 1980s, including the TRA of 1984, exhibited a markedly pro-business orientation.\textsuperscript{191} The imposition of substantial tax increases on foreign corporations' U.S. branch operations implies a congressional hostility, rather than tolerance, toward foreign business development. With the TRA of 1984 and TRA of 1986 Congress, therefore, sends contradictory messages to foreign and domestic investors by appealing to foreign debt but blocking its equity, and discouraging American saving but remaining supportive of its business capital.

\textbf{C. Tax Tactics for Playing the International Capital Market Game}

Congress's paradoxical tax treatment of foreign portfolio interest income and foreign business investments requires some refinement if the provisions are to coexist compatibly in the Code. To provide a complete exemption for portfolio interest on the one hand while surtaxing corporate profits on the other creates an irreconcilably broad gap in the country's international tax policy. The TRA of 1984 portrays an over-reaction on the part of Congress. The portfolio interest exemption sacrifices substantial tax revenue in exchange for a theoretical increase in foreign capital. That strategy lacks effec-

\begin{itemize}
\item activities such as limited partnerships;
\item (2) active income such as salaries; and
\item (3) portfolio income such as interest and dividends. Losses generated by passive activities can only offset passive income, not active income or portfolio income. (The Act allows the losses to carry over to future years if the taxpayer has no passive income in the current year.) The Act distinguishes between active and passive activities on the basis of the taxpayer's material participation; without material participation, the Act treats the trade or business as a passive activity. In evaluating material participation, the government looks to the taxpayer's knowledge or experience in the business, his physical proximity to the activity, and his relative involvement in the activity compared to other activities. \textit{A Complete Guide to the Tax Reform Act of 1986}, Fed. Taxes (P-H) \#\# 502-503 (Oct. 18, 1986) [hereinafter \textit{Complete Guide}].
\item \textit{Id.} \S 1101. The 1986 Act reduces the IRA contribution deduction for married taxpayers with adjusted gross income between $40,000 and $50,000, with the deduction eliminated for taxpayers with income in excess of $50,000. For unmarried taxpayers, the Act sets the bracket at $25,000 to $35,000. This reduction applies to taxpayers currently participating in an employer-sponsored retirement plan. \textit{Id.}
\item \textit{Id.} \S 141-143 (Aug. 13, 1981).
\end{itemize}
tiveness due to the Treasury's restrictive interpretations in recent Revenue Rulings and the applicable Code sections' complex statutory requirements. The technical hurdles that the government erected undermine Congress's objective of attracting foreign capital because investors cannot determine with any degree of certainty whether a particular bond will or will not qualify for the exemption.

Congress's goal in the TRA of 1984 consisted of attracting foreign capital to meet America's debt requirements without taxing the income to the extent it destroyed the investment's market competitiveness. The prior tax rate of thirty percent cut deep enough into the investor's net return to deter a significant volume of funds. The options before Congress, however, included more than the rather arbitrary thirty percent tax versus total exemption. Reducing the tax rate to a more palatable level such as ten percent would have provided a more practical compromise. A ten percent tax rate could produce several billion dollars in revenue. Given the security of U.S. investments, foreign investors should be willing to forgo a slightly higher rate of return in exchange for the greater security of the U.S. market.

To reduce reliance on foreign capital Congress should liberalize, rather than restrict, the opportunities for IRA investment. In the TRA of 1986 Congress slashed the deductible IRA contribution limit for mid- to upper-level income taxpayers who currently participate in an employer-sponsored retirement plan. Congress last increased the allowable IRA contribution deduction in 1982. If the government can justify providing tax-free interest income for nonresident aliens based on the inflow of foreign capital, it should offer similar incentives to U.S. savers. A repeal of the 1986 IRA constraints coupled with a $500 to $1,000 increase in the deduction limit would rekindle a savings stimulus.

Congress, in the TRA of 1986, devoted considerable effort to discouraging corporations from "treaty shopping." International tax treaties typically provide for reciprocal tax benefits between the participating countries. Congress's proliferation of treaties within the last twenty years creates a complex matrix of potential tax avoidance mechanisms that tax strategists will always seek to exploit. Congress would achieve better control over treaty shopping if it reexamined its treaty granting policy and sought to standardize the treaty benefits. As long as disproportionately generous tax

192. See supra note 1. With U.S. banks reporting $600 billion in foreign deposits in 1987, a portfolio interest tax of 10% should generate substantial revenue. Id.
195. See supra notes 162-174 and accompanying text.
196. In addition to providing for reduced withholding rates on investment income, many treaties contain provisions for tax-free wage income when nonresident aliens work in the treaty country. Most treaties contain at least a partial exemption from tax for teachers, students, artists, athletes, and employees on temporary assignment (usually less than 183 days). Publication 515, supra note 162, at 11.
refuges exist, the players in the international capital market game will find a way to fully utilize the loophole.

IV. CONCLUSION

In summary, the U.S. Government's international tax policy evolved over a long and convoluted development process. It originated simultaneously with its domestic tax policy, appearing as part of the corporate excise tax of 1909. Initially the tax system made no distinction in terms of rate between the tax assessed on business income and the tax imposed on passive or investment income of foreign entities. The Revenue Act of 1913, however, introduced the phrase "fixed or determinable annual or periodical" to describe certain payments and assessed a withholding obligation on all parties making such payments to nonresident aliens. Congress refined its tax treatment of foreign income with the Revenue Act of 1934. The statute attempted to assess a tax liability on, and impose a filing requirement for reporting, the gains from the sale of property that took place in the United States. When dealing with stock and other intangibles, however, defining the place of sale proved too difficult to enforce the tax effectively.

The Revenue Act of 1936 produced a fundamental shift in Congress's approach to taxing nonresident aliens and foreign corporations. The Act classified foreign entities according to the nature of their income. The statute viewed income as either business or investment income and applied different tax treatment according to that categorization.

With the exception of some refinement in definitions and slight broadening of the tax base, Congress made no major changes in its international tax policy until the mid 1960s. In 1963, Congress passed the Interest Equalization Tax as an attempt to deter domestic corporations from borrowing overseas. Several major changes also appeared in the Code in 1966. The major alteration, resulting from the Foreign Investor's Tax Act, restricted progressive tax rates to income "effectively connected" with a U.S. trade or business. Income that fell outside this definition remained subject to tax withholding.

Another eighteen years passed before Congress substantially revised the tax treatment of foreign investment or business income. In 1984 Congress seemingly acquiesced to the devices that U.S. corporations had fashioned for avoiding tax withholding obligations on interest paid to foreign entities. Congress repealed the withholding tax on "portfolio interest" paid to nonresident aliens and foreign corporations. The Tax Reform Act of 1984 imposed specific criteria for determining which bonds qualified for the withholding exemption and gave the Internal Revenue Service considerable latitude in refining the standards. The complex rules that ensued considerably weakened the attractiveness of the tax exemption.

The most recent shift in U.S. international tax policy came with the Tax Reform Act of 1986. The Act creates artificial dividends and interest payments between foreign parent corporations and their U.S. branch operations. The statute assesses a surtax on the parent corporation to represent tax that
the foreign corporation's U.S. subsidiary would normally collect on actual distributions of earnings from the subsidiary to the parent.

Reconciling Congress's underlying policy objectives in the development of its foreign tax law poses a difficult task. Congress appears to have seen the benefit of foreign capital as a source of funds to help finance the national debt without putting excessive strain on the domestic bond market. As foreign business began to compete effectively in the U.S. market, however, Congress realized that it lost substantial tax revenues due to foreign corporations' branches repatriating their earnings tax free.

Reliance on foreign capital as a means to help finance the national debt puts the United States in a vulnerable position not unlike its dependency on foreign oil. Rather than trying to lure the international capital market into U.S. investments by repealing tax withholding provisions, the government should seek to promote domestic saving. Congress could also raise significant tax revenues by reimposing tax withholding on portfolio interest, but at a rate that would keep U.S. debt instruments competitive with the Eurobond market. Making these changes would help to create a tax policy more consistent with the revenue-raising, U.S.-business-oriented objectives of the new Branch Profits Tax and Branch Level Interest Tax.