REPORT #734

TAX SECTION

New York State Bar Association

Report on the "Bank Loan" Exception

to the "Portfolio" Interest Rules

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OFFICERS
1992 - 1993
JOHN A. CORRY
Chair
450 Lexington Avenue
New York City 10117
212/530-4608
PETER C. CANELLOS
First Vice-Chair
299 Park Avenue
New York City 10171
212/371-9200
MICHAEL L. SCHLER
Second Vice-Chair
Worldwide Plaza
825 Eighth Avenue
New York City 10019
212/474-1588
CAROLYN JOY LEE ICHEL
Secretary
30 Rockefeller Plaza
New York City, NY 10112
212/903-8761

TAX SECTION

New York State Bar Association

August 28, 1992

The Honorable Fred T. Goldberg, Jr.
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Dear Assistant Secretary Goldberg:

Please find enclosed a report on the bank loan exception to the portfolio interest rules. It was prepared in response to an invitation by staff at the Internal Revenue Service and the Treasury Department to comment on how best to implement this exception.[1]

The report first suggests that the Service and Treasury could reasonably conclude that this exception would be best implemented, not by extensive regulations detailing every issue discussed in the report, but by limited regulations or revenue rulings dealing with certain basic issues. On the assumption that the Service and Treasury decide that detailed regulations are either necessary or desirable, the report then makes the following recommendations:

1. A foreign corporation should be considered to be a bank if it maintains a federal or state branch or agency in the United States, is subject to U.S. regulatory requirements or accepts deposits from and makes participations in loans to unrelated

[1] The report was prepared by a subcommittee that was chaired by Esta E. Stecher and that was composed of Richard E. Andersen, Reuven Avi-Yonah, Cynthia G. Beerbower, S. Douglas Borisky, John A. Corry, Edward C. DuMont, Andrew T. Feldstein, Jules Goodman, Stephen L. Gordon, Elizabeth Kessenides, Mark L. Lubin, David Mason, Christina Scobey, Jeffrey S. Sion, Po Y. Sit, Philip H. Spector and Mary Sue Teplitz. Helpful comments were received from Herbert L. Camp, Carolyn Joy Lee Ichel, Robert J. Staffaroni, Michael L. Schler, John Sykes, Willard B. Taylor and Ralph Winger.

persons (unless it maintains its principal office in a country that is a member of the OECD and would not be subject to U.S. regulatory requirements if it conducted these activities in the United States).

2. Although we have been unable to develop a single, bright line test that distinguishes between bank loans and other lending transactions, we list a number of factors which indicate that a debt obligation is not evidence of a bank loan and suggest these be incorporated in a "safe harbor" exclusion from the bank loan exception.

3. Interest received on a bank loan received by a nonbank should not be subject to the bank loan exception and, conversely, the bank loan exception should apply to interest received by a bank on a loan made by a nonbank that would be characterized on a bank loan if made by the bank.

4. Since the Service already has sufficient authority to attack "back-to-back" transactions, the regulations need not create a new set of rules to address this situation. However, it would be appropriate for the Service to provide a rule, limited to the bank loan exception, that treats interest received on an extension of credit made pursuant to a loan agreement by an intermediate entity as received by a non-U.S. bank partner or shareholder of the entity if the principal purpose for the establishment of the entity or the use of the entity to enter into the loan is the avoidance of the bank loan exception.

5. If a non-bank entity is not financed by back-to-back loans and is established for valid business reasons, the bank loan exception should not apply to it whether some or all of the holders of debt issued by or equity interests in the entity are banks.

6. Form W-8 should be revised to provide a place for a non-U.S. corporation to certify that it is a bank. In the absence of certification, a U.S. withholding agent should be able to treat interest paid on registered form indebtedness as received by a non-bank unless the withholding agent has actual knowledge or reason to know that the interest is received by a bank. In that event, the withholding agent should not be required to withhold unless the agent has actual knowledge or reason to know that the interest is received on an extension of credit made pursuant to a loan agreement. In the case of bearer form obligations, where the identity of the beneficial owner is unknown, it would be appropriate to require

withholding in any case where the withholding agent knows or has reason to know that the interest is paid on an extension of credit made pursuant to a loan agreement unless the holder of the bearer obligation establishes that the bank loan exception does not apply.

7. The bank loan exception should apply as a substantive tax matter to distributive shares of foreign corporate partners in a partnership that is a bank. On the other hand, a foreign bank's distributive share of interest received under a loan agreement made by a formal non-bank partnership in which it is £ partner (as contrasted with an informal partnership or joint venture) should not be subject to the bank loan exception, provided that the conduit or tax avoidance rules discussed in the report do not apply. Regardless of whether the bank loan exception applies to a foreign partner, it is not clear that the Service has statutory authority to require a U.S. withholding agent to withhold tax on interest payments received by a foreign partnership on extensions of credit made pursuant to loan agreements.

We would be pleased to discuss the report with you or members of your staff.

Very truly yours,

Jonn A. Corry
Chair

Identical Letter Sent to:

The Honorable Shirley Peterson
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, DC 20224

cc: Harry L. Gutman, Esq.
Chief of Staff
Joint Committee on Taxation
1015 LongsworthHouse Office Building
Washington, DC 20515

Abraham N.M. Shashy, Jr. Esq.
Chief Counsel
Internal Revenue Service
Room 3026
1111 Constitution Avenue, N.W.

Washington, DC 20224
Alan J. Wilensky, Esq.
Deputy Assistant Secretary of the Treasury for Tax Policy
Room 3108 Main Treasury
15 & Pennsylvania Avenue, N.W.
Washington, DC 20220

James Mogle, Esq.
Acting International Tax Counsel
Department of the Treasury
Room 4222 Main Treasury
15 & Pennsylvania Avenue, N.W.
Washington, DC 20220

Robert E. Culbertson, Esq.
Associate Chief Counsel (International)
Internal Revenue Service
Room 3052 CC: Int'l
1111 Constitution Avenue, N.W.
Washington, DC 20224

Carol Doran Klein
Branch Chief, Branch 3
Internal Revenue Service
Room 4555
1111 Constitution Avenue, N.W.
Washington, DC 20224

Carl M. Cooper
Attorney Advisor
Internal Revenue Service
Room 4704
1111 Constitution Avenue, N.W.
Washington, DC 20224

Leslie E. Berkowitz
Attorney Advisor
Internal Revenue Service
Room 4555
1111 Constitution Avenue, N.W.
Washington, DC 20224

Emily McMahon
Associate International Tax Counsel
Department of the Treasury
Room 4222 Main Treasury
15th & Pennsylvania Avenue, N.W.
Washington, DC 2022

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Report on the "Bank Loan" Exception to the "Portfolio" Interest Rules

This report, prepared by an ad hoc subcommittee (the "Subcommittee")[1]/ of members of the Tax Section, analyzes and recommends a framework for implementing the "bank loan" exception to the repeal of the 30% U.S. tax on U.S.-source interest received by non-U.S. corporations.[2]/ Part I discusses the history and purpose of the bank loan exception. Parts II and III discuss and make recommendations concerning the appropriate definitions of "bank" and "extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business" for purposes of the exception. Part IV discusses issues that arise in the context of secondary market and structured transactions. Part V discusses the circumstances under which the 30% tax should be collected by withholding. Finally, Part VI addresses certain issues that arise in applying the exception to partnerships.

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[1]/ The Subcommittee is chaired by Esta E. Stecher and is composed of Richard E. Andersen, Reuven Avi-Yonah, Cynthia G. Beerbower, S. Douglas Borisky, John A. Corry, Edward C. DuMont, Andrew T. Feldstein, Jules Goodman, Stephen L. Gordon, Elizabeth Kessenides, Mark L. Lubin, David Mason, Christina Scobey, Jeffrey S. Sion, Po Y. Sit, Philip H. Spector and Mary Sue Teplitz. Helpful comments were received from Herbert L. Camp, Carolyn Joy Lee Ichel, Robert J. Stafforoni, Michael L. Schler, John Sykes, Willard B. Taylor and Ralph Winger.

[2]/ Sections 881(c)(3)(A) and 1442 (a).

Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and to the Treasury regulations promulgated thereunder.

This report was prepared in response to an invitation by staff at the Internal Revenue Service (the “Service”) and the Treasury Department to comment on how best to implement the bank loan exception. The report's length should not, however, be construed as a recommendation that the Service promulgate extensive regulations on this subject. On the contrary, we do not believe that this area, which applies only to certain interest received by “banks” that are located in jurisdictions that do not have treaties with the United States that exempt interest from U.S. withholding tax, is in need of detailed clarification through regulations and the Tax Section strongly favors limiting the promulgation of complicated regulations to those areas where absolutely necessary. Further, it is not at all clear to us that the government's interest would be best served through lengthy regulations that establish definitively the parameters of the bank loan exception.

We think that the Service could reasonably conclude that the bank loan exception would best be implemented not by extensive regulations detailing every issue discussed in this report, but by limited regulations or a revenue ruling dealing with certain basic issues raised by the bank loan exception. If the Service were to make that decision, we would strongly encourage the Service to clarify the following points, all of which are discussed in more detail below: (i) that interest received by a bank on a “security” is not subject to the bank loan exception, (ii) that interest on a bank loan received by a non-bank is not subject to the bank loan exception and (iii) that the bank loan exception will not be applied to an entity that receives interest on a bank loan merely because the entity is a subsidiary of, under common control with or otherwise related to (through the ownership of debt issued by, or equity interests in, the entity) a bank, as long as the entity is not a conduit and was not formed or used principally for tax avoidance purposes.

I. HISTORY AND PURPOSE OF SECTION 881 (c)(3)(A)

Prior to passage of the Deficit Reduction Act of 1984 (the "1984 Act"),[3/] the United States imposed a 30% tax on U.S.-source interest received by non-U.S. persons to the extent that the interest was not effectively connected to the conduct of trade or business within the United States. Section 127 of the 1984 Act amended Sections 871 and 881 to eliminate the 30% tax on "portfolio" interest received on debt obligations issued after July 18, 1984. The definition of "portfolio" interest is comprehensive, but subject to certain exceptions. One such exception, embodied in Section 881(c)(3)(A), provides that "portfolio" interest does not include interest (other than interest on U.S. government obligations) that is

> received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.

The provisions repealing the 30% tax, including this "bank loan" exception, were added to the 1984 Act by the Senate Finance Committee. The Finance Committee and Conference Committee reports contain little more than references to the statutory language of Section 881(c)(3) and, thus, provide little indication of the purpose behind the bank loan exception.[4/] The general explanation of the 1984 Act prepared by the staff of the Joint Committee on Taxation,

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3/ Pub. L. No. 98-369, 98 Stat. 494 (July 18, 1984).

4/ S. Rep. No. 98-169, 98th Cong., 2d Sess. 416, 423 (1984); H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 936, 937-33 (1984) (the "Conference Report").

however, indicates that the bank loan exception was intended to address concerns regarding reserve requirements and the competitiveness of U.S. banks. The Joint Committee stated that

> [i]n addition to addressing a Federal Reserve concern regarding reserve requirements, the foreign bank exception was intended to prevent U.S. banks, which are subject to U.S. tax on interest income, from suffering a competitive disadvantage vis a vis foreign banks that make loans to U.S. persons.[5]/

This is the most authoritative statement of the exception's legislative purpose.[6]/

The available evidence of legislative purpose supports a strict reading of the narrow language of the bank loan exception. Because Congress was concerned with (i) foreign banks that would be subject to Federal Reserve Board reserve requirements if they were to operate in the United States and (ii) loans made by such banks in direct competition with loans made by U.S. banks in the ordinary course of business, we believe that the bank loan exception should be implemented in a manner that limits its operation to a clearly defined and relatively narrow set of entities and transactions, as set out below.

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[5]/ Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 395 (1984) (the “Blue Book”).

[6]/ Although not expressly indicated as a Congressional purpose in enacting the bank loan exception, the recently issued Treasury Integration Report (“Report”) indicates that the exception has given the United States leverage in obtaining withholding tax reductions in treaty negotiations. Chapter 4, endnote 33 of the Report. On balance, we do not believe that the narrow definition of “bank” described below will compromise this leverage because the entities that we assume provide all or substantially all of the leverage (i.e., big international banks) will fall squarely within the definition.

II. DEFINITION OF A "BANK"

The bank loan exception is limited to interest received by a foreign corporation that is a "bank".[7]/ As described in Section I, the history of the bank loan exception indicates that the term "bank" in this context was intended to encompass financial institutions similar to, and in direct competition with, U.S. banks subject to the reserve requirements of the Federal Reserve Board. A narrow definition of the term "bank" is further supported by the fact that Congress has consistently used broad, descriptive language when it intends a particular provision of the Internal Revenue Code to apply to both banks and other entities engaged in financial businesses. Examples of provisions where Congress has used such broad, descriptive language include:

> (i) Section 133(a)(1), enacted by the 1984 Act, which refers to both "a bank (within the meaning of section 581)" and "a corporation actively engaged in the business of lending money", thus indicating that at the time it enacted the bank loan exception Congress did not equate being engaged in a money lending business with being a bank;
>
> (ii) Section 279(c)(5) which refers to "any corporation which is a bank (as defined in section 581) or is primarily engaged in a lending or finance business," indicating by use of the disjunctive that Congress did not consider every corporation that is engaged in a lending or other finance business to be a bank;
>
> (iii) Section 864(c)(4)(B)(ii) (as well as Sections 904(d)(2)(B) and 954(c)(3)(B) of the Internal Revenue Code of 1954) which refers to the conduct of a "banking, financing or similar business;"[8]/
>
> (iv) Sections 871(h)(4) and 881(c)(2)(B) under which the statement required in order for interest on a registered form obligation to qualify as "portfolio" interest may be provided by a

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[7]/ The limitation on the scope of the bank loan exception to recipients that are foreign corporations and the issues raised by extensions of credit by foreign partnerships are discussed in section VI, below.

[8]/ See also Treas. Reg. §§ 1.864-5(b)(2)(i), 1.882-5(b)(2)(i), 1.884-4T(b)(3)(ii), 1.892-4T(c)(1)(iii),1.936-10(c)(3), 1.1445-3(e)(3)(ii), and Treas. Reg. § 1.954A-2(d)(2)(ii) issued under Section 954(c)(3)(B) of the Internal Revenue Code of 1954.

"securities clearing organization, a bank or other financial institution . . ."; and

(v) Section 904(d)(2)(C)(i) which refers to the "active conduct of a banking, insurance, financing, or similar business."

Language that encompasses both banks and entities other than banks that engage in financing or lending activities is conspicuously absent from Section 881(c)(3)(A).

In light of the legislative history and narrow statutory language, we believe that Congress intended the bank loan exception to apply only to a narrow category of financial institutions, and that the Federal banking and tax law definitions of the term "bank" are the relevant ones to consider in determining the proper definition for purposes of Section 881(c)(3)(A). These definitions are described below.

Banking Law Definitions. The term "depository institution" is used to describe the generic class of institutions that are subject to reserve requirements and are commonly thought of as "banks" (or as performing essentially the same economic function as banks).[9]/ The definition of "depository institution" includes various specific entities,[10]/ all of which must maintain reserves against a specified portion of their deposit accounts.

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[9]/ The Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. 96-221, 94 Stat. 132, imposed reserve requirements on all depository institutions, even though the powers and activities of the different types of institutions differed, because all took deposits and thus raised the same need for reserves.

[10]/ These are: (i) any bank the deposits of which are Federally insured or eligible for insurance; (ii) any mutual savings bank that is Federally insured or eligible for insurance; (iii) any stock savings bank that is Federally insured or eligible for insurance; (iv) any credit union that is insured or eligible for insurance; (v) any member of the Federal Home Loan Bank System; and (vi) any savings association that is Federally insured or eligible for insurance. Id. at § 103 (codified as amended at 12 U.S.C.A. § 461).

All depository institutions subject to reserve requirements (1) accept deposits (including, for this purpose, credit balances) and (2) engage in the business of making loans (whether commercial loans, consumer loans, or mortgages).

Other U.S. banking laws that define the term “bank” do so in different ways, depending upon their purposes. The Federal Deposit Insurance Act, for example, generally defines a “bank” as an institution “which is engaged in the business of receiving deposits.”[11]/ The Bank Holding Company Act (“BHCA”) defines a “bank” to include any institution that (1) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties and (2) is engaged in the business of making commercial loans.[12]/

In summary, although the Federal banking laws do not provide a single definition of the term “bank”, they do suggest that the relevant functional characteristics for identifying what have historically been considered “banks” are (1) accepting deposits and (2) engaging in the business of making loans.

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[11]/ 12 U.S.C.A. § 1813.

[12]/ 12 U.S.C.A. § 1841(C).

The BHCA7 s narrow definition of banks as institutions that make commercial loans reflects the historic division among commercial banks, thrifts (savings banks or savings and loan associations) and credit unions. Because thrifts were, until recently, restricted to making consumer and mortgage loans, the definition of “bank” in the BHCA was limited to institutions engaged in the business of making commercial loans. The Committee believes that the BHCA's focus on the making of commercial loans should not be given any particular weight in defining a bank for the purposes of Section 881(c)(3)(A).

Tax Law Definitions of a “Bank”. There are three tax law provisions that may be relevant in determining what constitutes a “bank” for purposes of Section 881(c)(3)(A).

First, Section 581 defines a “bank” as:

> a bank or trust company incorporated and doing business under the laws of the United States or of any State, a substantial part of the business of which consists” of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

This definition requires that a bank accept deposits[13]/ and make loans (or conduct a trust business) and also that a bank be subject to supervision by State or Federal authorities. See. e.g., Rev. Rul. 58-605[14]/ (an entity that qualified as an insurance company under state law, with fiduciary powers similar to those permitted to national banks under Section 11(k) of the Federal Reserve Act, does not qualify as a bank for purposes of Section 581 if it is not subject to the supervision of the state banking authorities).

Section 581 specifically includes “domestic building and loan associations” within the definition of the term “bank.” Under Section 7701(a)(19), domestic building and loan associations include domestic savings and loan associations, Federal savings and loan associations, and any other savings institution chartered and supervised as a savings and loan

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[13]/ Note that if an entity is authorized to accept deposits but does not actually receive them, it will not be considered a bank for purposes of Section 581. See Seattle First International Corp. v. United States, 79-2 U.S.T.C. f 9495 (W.D. Wash. 1979)

[14]/ 1958-2 C.B. 358.

association under federal or state law. Section 7701(a)(19)(B) further provides that the principal business of a domestic building and loan association must be the acquisition of savings from the public and the investment in loans, akin to the deposit and loan function of a bank under Section 581. Thus, apart from trust companies, both the deposit and loan functions of traditional banking entities are essential in order for a domestic entity to be considered a bank under Section 581.

Second, Notice 89-81[15]/ defines an "active foreign bank" for purposes of the exception from the definition of "passive income" in the passive foreign investment company ("PFIC") rules for income derived in the active conduct of a "banking business."[16]/ In order to qualify as an active foreign bank under the Notice, a foreign corporation must satisfy the following three requirements.

> (1) The foreign corporation must regularly accept deposits and make loans in the ordinary course of its trade or business.[17]/ The Notice provides that a foreign corporation will be treated as accepting deposits in the ordinary course of its trade or business only if (i) the average for the taxable year of deposits accepted by the corporation from unrelated persons equals at least 50 percent of the average of total liabilities of the corporation for the year and (ii) the foreign corporation has at least 1,000 depositors who are unrelated to the corporation and are citizens or residents of the country in which the foreign corporation is licensed to accept deposits. A foreign corporation will be treated as making loans in the ordinary course of its trade or business if at least 50 percent of the average principal for the taxable year of all loans outstanding during the corporation's taxable year is owed by unrelated persons.

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[15]/ 1989-2 C.B. 399.

[16]/ Section 1296(b)(2)(A).

[17]/ This requirement can also be satisfied by a foreign corporation that is a "qualified affiliate", i.e., a foreign corporation that (a) conducts at least one of the fourteen banking activities enumerated in paragraph (2) in the text and (b) is an affiliate of a corporation that either (i) conducts a banking business in the United States pursuant to a U.S. bank license or (ii) is an active foreign bank that regularly accepts deposits and makes loans in the ordinary course of its trade or business.

(2) The foreign corporation must derive at least 60 percent of its total gross income from one or more of fourteen enumerated banking activities which include: (a) accepting deposits, (b) making loans, (c) factoring, (d) purchasing, selling, discounting or negotiating notes, drafts, checks, bills of exchange or other evidences of indebtedness, (e) issuing letters of credit and negotiating drafts drawn thereunder, (f) performing trust services, (g) arranging or engaging in foreign exchange transactions, (h) entering into interest rate and currency swaps, (i) underwriting securities, (j) providing charge or credit card services, or factoring receivables obtained in the course of providing such services, (k) providing traveller's check and money order services, (1) providing correspondent bank services, (m) providing paying agency and collection agency services and (n) any other activity that the Commissioner determines to be a commercial banking activity.

(3) The foreign corporation (other than a “qualified affiliate”) must be licensed to conduct banking activities in, and be subject to regulation by the banking regulatory authorities of, its home jurisdiction.

Thus, once again, it is fundamental to classification as a “bank” that the foreign corporation accepts deposits and makes loans.

Finally, under Section 954(c)(2)(B) and Treas. Reg. § 1.954-2T(b)(2)(ii), export financing interest derived by a controlled foreign corporation is not foreign personal holding company income if the interest is derived in the conduct of a “banking business”, i.e., if, in connection with the financing from which the interest is derived, the corporation, through its own officers or staff of employees, engages in all the activities in which banks customarily engage in issuing and servicing a loan. This definition of a “banking business”, which was added to the law after the bank loan exception was enacted, is the only definition we found that suggests that a corporation may be a “bank” regardless of whether it accepts deposits from the public, so long as it both issues and services loans.

Recommended Definition of "Bank" for Purposes of Section 881(c)(3)(A). On balance, we think that the legislative history of the bank loan exception, the narrow statutory language and the above definitions suggest that the following two rules should apply in determining whether a foreign corporation is a "bank" for purposes of the bank loan exception:

> (i) A foreign corporation will be considered to be a bank if it maintains in the United States a Federal branch, Federal agency. State branch or State agency (as those terms are defined in §l(b) of the International Banking Act of 1978)[18]/ and is subject to regulatory requirements of the Federal Reserve Board, Comptroller of the Currency, Federal Deposit Insurance Corporation or an equivalent bank regulatory authority of a State or the District of Columbia.
>
> (ii) A foreign corporation will be considered to be a bank if it accepts deposits from,[19]/ and makes or participates in loans to, unrelated persons in the ordinary course of its trade or business (i.e., the banking business),[20]

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[18]/ 12 U.S.C.A. § 3101(b)

[19]/ In light of the narrow purpose of the exception, the term "deposit" should be limited to traditional bank deposits and should not include, for example, amounts held by an insurance company under an agreement to pay interest thereon. Cf. Section 871(i)(3) which, in defining the term "deposit," includes deposits with persons carrying on a banking business and amounts held by insurance companies.

[20]/ Because the legislative purpose of the bank loan exception differs significantly from the purpose underlying the banking exception to the definition of passive income in the PFIC rules, we think that the standards of Notice 89-81 may be too high for purposes of determining whether the foreign corporation takes deposits and makes loans to unrelated persons in the ordinary course of its trade or business, and that any significant level of taking deposits and making loans should create a presumption that a foreign corporation is a bank. Such a presumption could be rebutted by a showing that such activity is not in the ordinary course of the foreign corporation's trade or business.

In addition, because of the differing legislative purposes, we do not believe that standards of Notice 89-81 relating to sources of income should apply.

> unless the foreign corporation (a) maintains its principal office in a country that is a member of the Organization for Economic Cooperation and Development ("OECD")[21]/, conducts both such activities from such principal office and is not subject to the regulatory requirements of the banking authorities in that country[22]/ or (b) would not be subject to the regulatory requirements described in (i) if it conducted both such activities in the United States.

We do not think that it would be appropriate to treat as a "bank" for purposes of the bank loan exception all foreign corporations that are regulated by the banking authorities in any jurisdiction in which they do business. We understand that in jurisdictions that do not have laws similar to the "Glass-Steagall" law of the United States (which requires separation of investment and commercial banking activities), the banking authorities may regulate the activities of investment and merchant banks that do not accept deposits in the ordinary course of business.

It would be helpful if the regulations implementing the bank loan exception would illustrate the application of the bank definition to foreign corporations that are, for example, leasing or finance companies. These entities ordinarily raise capital by issuing commercial paper or debt securities, and do not accept deposits. Thus, we believe that they should not be treated as banks for purposes of the bank loan exception.

21/ The OECD includes the following countries: Australia, Austria, Belgium, Canada, Denmark, the Federal Republic of Germany, Finland, France, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

22/ We believe that the countries that are members of the OECD generally regulate those entities that take deposits and make or participate in loans in the ordinary course of their trade or business.

We also believe that the regulations should clarify that a foreign corporation will not be subject to the bank loan exception merely because it is a subsidiary of, under common control with or otherwise related to (through the ownership of debt issued by, or equity interests in, the foreign corporation) a non-U.S. bank. While the Service may have legitimate concerns regarding the formation of non-bank entities that make loans into the United States and finance their activities with "back-to-back" loans from a non-U.S. bank, such situations can be dealt with through existing authority (discussed in greater detail in Section IV(B), below). A regulatory presumption that treats non-bank entities that are in any way related to non-U.S. banks as "banks" for purposes of the bank loan exception would curtail financing activity that we believe the exception was not intended to reach.[23]/

III. DEFINITION OF A BANK LOAN

The bank loan exception is limited to interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[24]/ Although this clause could be parsed into as many as three separate and distinct tests -- i.e., what is an "extension

[23]/ For example, we understand that certain non-U.S. banks have investment and merchant banking subsidiaries that may extend credit to U.S. persons. The subsidiaries have bona fide corporate existences, and there is no conduit element to these transactions. Subjecting this type of activity to the bank loan exception would, we believe, exceed the intended scope of the exception.

[24]/ The legislative history of the bank loan exception indicates that Congress intended that the exception would apply as well to "[i]nterest on any obligation that performs the function of a loan entered into in the ordinary course of banking business [sic]," but that it may not apply to "[i]nterest on an obligation that does not perform that function - for example, a Eurobond held by a foreign bank as an investment asset." Blue Book at 395.

of credit"? what is a "loan agreement"? and what is the "ordinary course of its [the bank's] trade or business"? -- we believe that the "extension of credit" language cannot usefully be separated from the "loan agreement" language and that, because of the nature of the activities of banks, as defined above, loan agreements entered into by such banks should be presumed to be entered into in the ordinary course of a bank's trade or business.[25]/ Accordingly, the critical issue becomes what is a "loan agreement" as opposed to some other debt obligation held by a bank?

We have been unable to develop a single, bright line test that distinguishes loan agreements and transactions that perform a similar function (hereinafter, "loan agreements") from all other lending transactions entered into by banks (e.g., purchases of notes or other securities or investments). The documentation and circumstances surrounding a bank's investment in a note purchase agreement or publicly offered note issue may have characteristics that are also found in typical loan agreements, particularly when the note purchasers are few in number. We were, however, able to identify a variety of obligations which, as a result of one or more features (including, in particular, that they generally are "securities" for purposes of the Securities Act of 1933 (the "1933 Act"), whereas bank loans and loan participations generally are not "securities"),[26]/ should fall outside the definition of "loan agreement."

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[25]/ A bank should be permitted, however, to rebut this presumption by showing that the loan agreement was entered into as an investment.

[26]/ See, e.g., Banco Espanol de Credito. et al v. Security Pacific National Bank, 1992 U.S. App. LEXIS 14563 (2d Cir. 1992) (Loan participations sold by bank to both banks and non-banks held to be analogous to bank loans and not, therefore, securities under the Securities Act of 1933). We understand that a petition for rehearing en banc in this case is currently pending.

We believe, therefore, that interest on such obligations (described below) should be entitled to a "safe harbor" exclusion from the bank loan exception. This will help ensure that the regulations implementing the bank loan exception do not unduly interfere with the efficient operation of the securities markets.[27]/

We also believe that a factor-based analysis should be applied to determine whether obligations that fall outside the safe harbor should be treated as "loan agreements" and we set out below a number of factors that we think may be indicative of a typical "extension of credit made pursuant to a loan agreement."

The regulations implementing the bank loan exception should establish a "safe harbor" for the following debt obligations, provided that the debt obligations are freely transferable or would be freely transferable but for applicable securities law restrictions:

> 1. Debt obligations that are (or are part of an issue or series of obligations a substantial portion of which is) registered with the Securities and Exchange Commission ("SEC");
>
> 2. Debt obligations that are (or are part of an issue or series of obligations a substantial portion of which is) exempt from registration under Section 5 of the 1933 Act but would be required to be registered with the SEC if issued in the same manner in the United States;[28]/
>
> 3. Debt obligations that are (or are part of an issue or series of obligations a substantial portion of which is) exempt from registration under the 1933 Act because of the issuer or the

[27]/ The Service has recognized that the acquisition of a security (as defined in Treas. Reg. § 1.864-4(c)(5)(v)) generally is not a loan. See Section 3(b) of Notice 89-81.

[28]/ Thus, for example, under 2, if a substantial portion of an issue is sold in reliance on the exemption from registration in Regulation S, such obligations, as well as obligations that are sold in the United States pursuant to Rule 144A or Section 4(2) of the 1933 Act, would qualify for the safe harbor.

exemption in Section 3(a)(3) of the 1933 Act[29]/ or that would be so exempt if issued in the same manner in the United States; and

4. Debt obligations substantially all the terms and conditions of which (including all of the covenants and representations of the borrower) are fixed in documentation (e.g., a trust indenture, fiscal agency agreement, dealer agreement or similar agreement) that is negotiated between the borrower and a dealer, underwriter or placement agent acting in its capacity as such (and not as agent for the lender) (which dealer, underwriter or placement agent may be a non- U.S. bank), provided that interest rate, maturity date, currency, form (i.e., registered or bearer) and other similar terms may be varied for any particular debt obligation.

In general, we think that the most fundamental characteristic of a loan agreement that distinguishes it from other debt obligations is that there are direct negotiations between the borrower and the lender(s)[30]/ and among the lenders. We believe that these direct negotiations should be used as the guidepost in a factorbased analysis used to construe the phrase “an extension of credit made pursuant to a loan agreement” with respect to obligations that fall outside of the “safe harbor” described above and that the existence of a material number of the following factors may be indicative of a loan agreement:

(a) direct negotiations between one or more lenders and the borrower resulting in a loan agreement, credit agreement, or similar document signed by both the borrower and the lender(s);

(b) negotiated restrictions on the borrower's operations, corporate structure and financial structure; for example:

(i) affirmative covenants such as covenants requiring the borrower to maintain its corporate existence;

[29]/ This is intended to cover, for example, (i) securities issued by institutions that are granted specific exemptions from registration (e.g., Fannie Mae), (ii) securities issued by banks that are exempt from registration under Section 3(a)(2) of the 1933 Act regardless of where they are issued, and (iii) commercial paper that is issued for “current transactions” and is exempt from registration under Section 3(a)(3) of the 1933 Act.

[30]/ In general, we do not think that dealers, underwriters or placement agents of securities that purchase securities for purposes of resale should be treated as “lenders” for this purpose, even if they cannot sell the securities that they purchase and for some period hold them for their own account.

comply with applicable laws; notify the lender of material litigation; pay taxes when due; notify the lender as to changes in employee benefit plans; notify the lender of labor disputes, defaults under contractual obligations, and environmental claims; furnish to the lenders copies of reports filed with the SEC and nonpublic information regarding the borrower's financial condition; permit the lender access to accounting books and records; or use the proceeds of the loan only as provided in the loan agreement;

(ii) negative covenants such as covenants restricting the borrower's ability to incur liens on the borrower's properties; incur indebtedness in addition to the loan made by the lender; make investments; pay dividends or other distributions to shareholders; consolidate or merge with other corporate entities; sell or transfer assets other than in the ordinary course of the borrower's business; or conduct new businesses; and

(iii) financial covenants such as covenants requiring the borrower to satisfy negotiated interest coverage ratios, debt-equity ratios and net worth thresholds;

(c) significant participation by one or more lenders in the process of making the loan, evidenced by drafting of documents by counsel for lender(s);

(d) a requirement that assignees of interests in the loan either obtain the permission of the borrower or execute an agreement with the borrower or other lender(s) (subject to an exception for assignments to governmental authorities); and

(e) if there are multiple lenders and one lender is acting as agent, a requirement that all lenders sign the agreement with the borrower.

We understand that there may be debt obligations that fall outside of the safe harbor but do not materially involve the indicia of a loan agreement described above and think that such obligations should not be subject to the bank loan exception.

We believe that in order to provide workable guidance, the regulations implementing the bank loan exception should include examples describing debt obligations that do and that do not qualify as “extensions of credit pursuant to loan agreements”. Such examples might include the following:

1. Bank A, a non-U.S. corporation, and Company C, a U.S. corporation, execute an agreement pursuant to which Bank A lends $100 million

to Company C. Prior to executing the agreement, Bank A and Company C directly negotiate various terms, including rights upon default and financial covenants. The agreement requires that Bank A obtain the consent of Company C before it transfers its interest in whole or in part. The agreement between Bank A and Company C is a loan agreement.

2. Bank A, a non-U.S. corporation, accepts deposits, makes loans and underwrites debt obligations in the ordinary course of its trade or business in Country B. When it is the lead underwriter of a Eurobond offering for a U.S. borrower, Bank A directly participates in negotiations with the borrower that result in a dealer agreement. The notes issued in the Eurobond offering are freely transferable. The notes are not issued pursuant to a loan agreement.

3. Bank A, a non-U.S. corporation, purchases a medium term note issued by Company B, a U.S. corporation, through Dealer C, a non-U.S. underwriter. The covenants and representations of the borrower are fixed in a fiscal agency agreement that was negotiated between Company B and Dealer C. However, the term, currency of issue and interest rate on the medium term note satisfy the specifications of Bank A. The medium term note is freely transferable. The medium term note is not issued pursuant to a loan agreement.

IV. SECONDARY MARKET AND STRUCTURED TRANSACTIONS

A. Secondary Market Transactions

In general, we believe that if a bank receives interest on an obligation that qualifies as “an extension of credit made pursuant to a loan agreement”, the interest should be subject to the bank loan exception regardless of whether the loan is originated or later acquired by the bank in the ordinary course of its trade or business. Thus, the bank loan exception should apply to interest received by a bank if (i) an “extension of credit made pursuant to a loan agreement” is originated by a person that is not a bank and a participation in the loan[31]/ or the entire loan is later sold or assigned to a bank or (ii) an “extension of credit made pursuant to a loan agreement” is originated by a bank, later sold (in whole or in part) to a non-

[31]/ We have assumed that a loan participation is not considered to be a separate loan by the purchaser to the seller, a complex issue that may turn on factors such as the existence of recourse to the seller, agreements to act vis a vis the borrower, etc.

bank, and reacquired by the originator or another bank. Notwithstanding that this rule may not fall squarely within the literal words of section 881(c)(3)(A), which provides that the bank loan exception applies only in the case of a loan agreement "entered into" in the ordinary course of a bank's trade or business, we recommend the rule both for simplicity and because the purposes of the bank loan exception would be easily frustrated if other possible rules were to apply (e.g., if the bank loan exception only applied when a bank originated a loan, or if a loan originated by a bank ceased to be characterized as such if acquired by a non-bank, even if subsequently reacquired by a bank).[32]/

Conversely, if a loan is originated by a bank and a participation in the loan or the entire loan is later sold or assigned to a "non-bank," the bank loan exception should not apply to interest payments received by the non-bank. Section 881(c)(3)(A) is explicitly limited to interest "received by a bank," and there is no policy reason to impede transactions between banks and non-banks by imposing unwarranted tax consequences on the latter. The regulations implementing the bank loan exception should provide an example reaffirming the statutory rule that interest on a bank loan that is received by a non-bank is not subject to the exception.

B. Structured Transactions

1. "Back-to-back" loans. The legislative history of the bank loan exception refers briefly to the possible use of "back-to-back" loans through "an unrelated foreign party" to

[32]/ Because this rule may be outside the literal words of the statute, it would be appropriate to apply it prospectively only to loans made after the date that the regulations implementing the bank loan exception are issued.

circumvent the bank loan exception, and directs the Service to use “means at its disposal” to determine whether such loans exist.[33]/ we think it would be appropriate for the Service to include in the regulations implementing the bank loan exception examples providing that in a “back-to-back” loan situation the interest is not “received by” the financing vehicle, but rather is “received by” the bank. We do not, however, think that the regulations implementing the bank loan exception need to create a new set of rules to address this situation, because a sufficient arsenal of authority already exists for attacking “back-to-back” loan arrangements.

This conduit issue is by no means unique to the context of the bank loan exception. The leading case for treating a corporation as a conduit for Federal income tax purposes is Aiken Industries. Inc. v. Commissioner.[34]/ In that case, a Bahamian corporation transferred a note of a U.S. subsidiary to a Honduran corporation in exchange for notes of the Honduran corporation. The interest paid by the Honduran corporation on its notes matched the interest it received on the note of the U.S. subsidiary. The Tax Court held that the interest payments were not “received by” the Honduran corporation and therefore were not eligible for the exemption from withholding under the U.S.-Honduras Income Tax Convention. The court referred to the Honduran corporation as a “collection agent” and a mere “conduit” for the interest payment on the basis that the transfer of a note from the Bahamian parent to the Honduran

[33]/ See Conference Report at 937-38; Blue Book at 395. Because the statement refers to the use of “back-to- back” loans to circumvent either the bank loan exception or the rule that excludes from the definition of “portfolio” interest interest paid to a 10% or greater shareholder, we do not believe that the reference to an “unrelated” party, rather than any party, is particularly relevant.

[34]/ 56 T.C. 925 (1971).

corporation did not have "any valid economic or business purposes."[35]

Further, the Service has ruled[36] that even in cases where an intermediary corporation earns a "spread" (i.e., the excess of interest income over interest expense), the interest income will not be treated as "derived by" the intermediary corporation if the transaction does not have sufficient business or economic purpose, independent of tax avoidance, to overcome the conduit nature of the transaction. Revenue Ruling 84-152 involved a Netherlands Antilles subsidiary that borrowed money from its Swiss parent and loaned the proceeds of the borrowing to a U.S. subsidiary of the parent. In Revenue Ruling 84-153, a foreign corporation arranged to have its Netherlands Antilles subsidiary issue bonds to foreign persons in public offerings outside the United States. The Netherlands Antilles subsidiary loaned the proceeds from the bond offerings to a U.S. subsidiary of the foreign parent corporation. In both revenue rulings (the "conduit rulings"), the Service applied the holding of Aiken Industries, even though the intermediary Netherlands Antilles corporations were adequately capitalized and earned a significant "spread" on the transaction, and ruled that interest paid by the U.S. subsidiary would not qualify for exemption from withholding pursuant to the tax treaty between the United States and the Netherlands. See also Rev. Rul. 87-89, 1987-2 C.B. 195, in which the Service ruled in three different situations that an unrelated intermediary should be disregarded in the flow of funds between related domestic and foreign entities because,

[35]/ Id. at 934. The court stated that the only purpose for the transaction was to obtain the treaty benefits for the interest payments and that "such a motive standing by itself is not a business purpose which is sufficient to support a transaction for tax purposes". Id.

[36]/ Rev. Rul. 84-152, 1984-2 C.B. 381, and Rev. Rul. 84-153, 1984-2 C.B. 383.

in each case, the intermediate step would not have been undertaken except as part of the entire transaction.

Aiken Industries and the conduit rulings rely, wholly apart from the question of whether the identity of the intermediary corporation is to be respected, on whether the intermediary corporation can be said to have "dominion and control" over the interest received, which in turn rests on whether the transactions in question have an independent business purpose. The conduit rulings indicate in addition that even if a transaction has some business purpose, the business or economic purpose may not be sufficient to overcome the conduit nature of the transaction in question. These are the standards that should be applied to back-to- back loans in the context of the bank loan exception.

2. Tax-motivated transactions that fall outside the scope of the "back-to-back" loan rules. The legislative history of the bank loan exception does not articulate a specific concern with the possible circumvention of the rule in situations other than those in which "back-to-back" loans exist. It might be possible, however, to circumvent the bank loan exception through the use of partnerships and tax haven corporations that receive interest from a U.S. borrower on an obligation that is "an extension of credit made pursuant to a loan agreement" in situations where (i) such entities are conduit financing vehicles that finance their lending activities with "back-to-back" capital contributions from non-U.S. banks (i.e., the entity has no independent management or substantial business or economic purpose for its existence and cash flows to the partners or equity holders substantially match, in amount and timing, the interest received on loans made to U.S. borrowers) or (ii) such

entities are owned by banks and established for the principal purpose of circumventing the bank loan exception.

We believe that the legislative history of the bank loan exception indicates that Congress was concerned with blatant circumvention of the bank loan exception and that the Service may have legitimate concerns regarding the use of tax avoidance vehicles in this context. While we do not generally endorse an expansion of the holdings in Aiken Industries and the conduit rulings and we do not concede the validity of the recent expansion of these holdings by the Service,[37]/ we think that the regulations implementing the bank loan exception could contain a rule, limited to the bank loan exception, that permits the Service to treat interest received on “an extension of credit made pursuant to a loan agreement” by an intermediate entity as received by a non-U.S. bank partner or shareholder of the entity if the principal purpose for the establishment of the entity or the use of the entity to enter into the loan is the avoidance of the bank loan exception. It would be useful for the regulations to provide examples of situations in which this principle would be applied.[38]/

3. Structured transactions that are not tax motivated. We believe that if a non-bank entity that is not financed by “back-to-back” loans is established for valid business reasons,

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[37]/ The Service has taken the position that the holding in Aiken Industries and the conduit rulings should be extended to situations where the intermediate financing vehicle is financed with equity. See, e.g., G.C.M.'s 39845 through 39851 (June 3, 1991) (each revoking a prior GCM to the extent inconsistent with the conduit rulings).

[38]/ One factor that might be considered in determining tax avoidance purpose is whether the entity is managed by a non-U.S. bank.

the bank loan exception should not apply to interest received by the entity regardless of whether some or all of the holders of debt issued by, or equity interests in, the entity are banks. For example, assume that a special purpose foreign corporation (i) acquires a portfolio of bank loans to U.S. persons from U.S. and non-U.S. banks that, for valid business purposes, want to diversify their loan portfolios and reduce credit exposure to certain classes of borrowers and (ii) issues several series of debt and/or equity interests in the public markets the terms of which do not track the terms of the loan portfolio. We think that interest on the loans received by the special purpose foreign corporation should qualify for the portfolio interest exemption without regard to the identity of its equity and debt holders and that interest paid by the non-U.S. corporation should be treated as foreign source interest for U.S. tax purposes.

V. DUTY TO WITHHOLD

Section 1442(a), when read together with Section 1441(c)(9), provides that

> [I]n the case of portfolio interest (within the meaning of 881(c)), no tax shall be required to be deducted and withheld from such interest unless the person required to deduct and withhold tax from such interest knows, or has reason to know, that such interest is not portfolio interest by reason of section 881(c)(3).

The legislative history of these provisions, which were added by the 1984 Act in connection with the repeal of the 30% tax on “portfolio” interest, clarifies that an explicit duty to withhold tax at the 30% rate only arises if the withholding agent knows, or has reason to know, that the recipient “is a bank and the interest is received on an extension of credit pursuant to a loan agreement entered into in the ordinary course of the bank's business."[39]/ The report of the Senate Finance Committee also indicates that these provisions would not affect the ability of the Secretary to require withholding when the payor does not know the identity of the beneficial owner of the securities on which the interest is paid.[40]/

We think that the plain language of these provisions, as well as their legislative history, indicate that Congress did not intend to impose on withholding agents a duty to inquire into the status of payees or, where the identity of the payees is known to the withholding agent, to impose withholding unless the payees establish that they are not banks.[41]/ We also believe that it is essential to the efficient operation of the securities markets that withholding agents be able to determine their withholding obligations with a fair degree of certainty. In the case of registered form obligations, where the beneficial owner of the interest must provide the withholding agent with Form W- 8 and the withholding agent therefore knows the identity of the beneficial owner, we believe that these two interests would be appropriately balanced if the withholding tax rules worked as follows:

> (i) Form W-8 would be revised to provide a place for a non-U.S. corporation[42]/ to certify that it is a bank. If a withholding agent receives a Form W-8 that does not contain the bank

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[39]/ S. Rep. No. 98-169, supra. at 423; Blue Book at 397.

[40]/ S. Rep. No. 98-169, supra at 423.

[41]/ This conclusion is supported by the fact that other provisions of the Internal Revenue Code that use the phrase "knows or has reason to know" have not been implemented in a manner that imposes an affirmative duty to inquire into the relevant facts and circumstances. See, e.g., Section 999(a)(1)(B) and Notice 84-1, 1984-1 C.B. 328, Q&A C-l, and Section 6050J(a)(2) and Treas. Reg. § 1.6050J-1T, Q&A-19. Recently issued proposed regulations which use the same language similarly do not impose an affirmative duty to investigate. See Prop. Reg. § 1.861-8(e)(12)(ii).

[42]/ See the discussion of partnerships in section VI, below.

certification, the withholding agent should be able to treat interest as “received by” a non-bank (i.e., the withholding agent should be allowed to assume that the person who is indicated on the Form as the beneficial owner is in fact the beneficial owner and that such person is not a bank) unless the withholding agent has actual knowledge or reason to know that the interest is “received by” a person that is a bank. We think it would be appropriate for the Service to provide that a withholding agent has “reason to know” that interest is •received by” a bank if the name of the beneficial owner on Form W-8 reasonably indicates that it is a bank[43]/.

(ii) Even if a withholding agent has actual knowledge or reason to know that the beneficial owner of the interest is a bank, the withholding agent should not be required to withhold unless the agent also has actual knowledge or has reason to know that the interest is received on “an extension of credit made pursuant to a loan agreement”.[44]/

In the case of bearer form obligations, where the identity of the beneficial owner of the interest is unknown, we believe that the legislative history provides authority to the Secretary to require withholding in any case where the withholding agent knows or has reason to know that the interest is paid on “an extension of credit made pursuant to a loan-agreement”. In such a case, it may be appropriate to provide for voluntary identification by the beneficial owners of the bearer form obligations so that they may establish that interest on the obligations does not fall within the bank loan exception.

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[43]/ Withholding agents are used to looking at the names of financial institutions in order to determine whether the financial institutions are “exempt recipients” for backup withholding purposes. See, e.g., Treas. Reg. §§ 5f.6045-1(b) and 1.6049-4(c)(1).

[44]/ We do not think that the mere fact that a beneficial owner of the interest is a bank standing alone gives a withholding agent a “reason to know” that the interest is paid on “an extension of credit made pursuant to a loan agreement”. It might be appropriate, however, for the regulations implementing the bank loan exception to provide that, absent actual knowledge to the contrary, a withholding agent has “reason to know” that interest is paid on “an extension of credit made pursuant to a loan agreement” if such interest is paid to a bank on an obligation other than an obligation that is described in one of the “safe harbors” discussed above in section III.

VI. PARTNERSHIPS

By its terms, Section 881(c)(3)(A) only applies if the recipient of the interest is a foreign corporation.[45]/ This limitation on the literal scope of the exception raises the question of how to treat interest on an extension of credit made pursuant to a loan agreement that is received by a partnership that (i) is itself a bank and has one or more foreign corporations as partners or (ii) is not itself a bank but has one or more foreign banks as partners. This question has been the most difficult one for the Subcommittee.

In general, we believe that for purposes of the substantive tax liability of Section 881(c)(3)(A), the bank loan exception should apply to the foreign corporate partners' distributive shares of the interest received by a partnership that is a bank. This result is not inconsistent with the statutory language, if read in light of the principles that (a) treat separately certain items of partnership income[46]/ and (b) treat partners as engaged in the business conducted by the partnership.[47]/

On the other hand, we do not think that a foreign bank's distributive share of interest received on an extension of credit made pursuant to a loan agreement by a formal non-bank

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[45]/ Section 881(a)(1) imposes tax on interest received by foreign corporations and Section 881(c) exempts portfolio interest from the tax imposed by Section 881(a)(1). The bank loan exception in Section 881(c)(3) applies only to Section 881(c) and, therefore, only to foreign corporations. The portfolio interest exemption for nonresident alien individuals provided in Section 871(h) has no bank loan exception.

[46]/ See Code Section 702(a); Treas. Reg. § 1.702- 1(a)(8)(2)(i); Rev. Rul. 71-141, 1971-1 C.B. 21.

[47]/ See, e.g., Section 875.

partnership in which it is a partner (but not an informal partnership or joint venture in which it is a member) should be subject to the bank loan exception, provided that the conduit or tax avoidance rules described above do not apply. As stated above, we do not believe that interest received by a non-conduit, non-tax motivated foreign corporation should be subject to the bank loan exception and we see no reason to treat partnerships differently. (The economics of a partnership can, in many situations, be duplicated through the use of a tax-haven corporation; accordingly, we believe that no effective distinction can be drawn between corporations and partnerships.)

Because the non-U.S. partners in a partnership, and not the partnership itself, are subject to the 30% tax imposed by Sections 871(a) and 881(a), we generally believe that the exceptions to the portfolio interest rules should be determined at the partner level. In particular, we think that the "10% shareholder" and "related CFC" exceptions of Sections 871(h)(3), 881(c)(3)(B) and (C) should be determined by reference to the status of the particular partner. Our recommendations for construing the bank loan exception are consistent with a partner-level analysis in that the exception would only apply to partners that are foreign corporations. However, the bank loan exception also requires that the interest be "received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business". We believe that it is appropriate to analyze this requirement on an entity basis and that the determination of whether a foreign corporate partner should be treated as (i) a bank, and (ii) receiving interest on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of the banking business should, except in conduit and tax-motivated situations, be made by reference to the partnership's activities.

Regardless of whether the bank loan exception should apply, as a substantive matter, to a foreign corporation's distributive share of certain partnership income, it is not clear that the Service has statutory authority to require a U.S. withholding agent to impose withholding tax on interest payments received by foreign partnerships on extensions of credit made pursuant to loan agreements. Section 1441 and Treas. Reg. § 1.1441-3(f) clearly treat foreign partnerships as the recipients of income for withholding tax purposes without regard to the identity of the partners, and Section 1441(c)(9), without the changes made to its terms by Section 1442(a) (which applies only to foreign corporations), makes no reference to the bank loan exception.

It is not entirely certain that the statutory incongruence between the potential scope of the substantive tax liability under Section 881(c)(3)(A) and the ability to collect that tax through withholding under Section 1442(a) can be resolved through Treasury Regulations alone and we recommend that if the Service is concerned about this incongruence, it consider seeking a legislative change. We would not support, however, any legislative change or administrative interpretation that would require a withholding agent (except, possibly, if the withholding agent is the borrower (but not the borrower's agent or another third party)) to inquire into the identity or status of partners in a partnership. There is no precedent for this type of withholding tax scheme[48]/ and, in our view, it would not be administrable.

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[48]/ Cf. Treas. Reg. § 1.1441-3(f).