REPORT #853

TAX SECTION

New York State Bar Association

Taxation of U.S. Stock Gains of
Foreign Shareholders and Limitation on
Treaty Benefits Provisions

January 12, 1989

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TAX SECTION
New York State Bar Association

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November 9,1995

The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate
104 Hart Senate Office Building
Washington, D.C. 20510

Re: Taxation of U.S. Stock Gains of Foreign Shareholders and Limitation on Treaty Benefits Provisions

Dear Mr. Chairman:

I am writing on behalf of the Tax Section of the New York State Bar Association to convey our strong opposition to the enactment of the provisions included in Sections 12882 and 12883 of H.R. 2491 (as passed by the Senate on October 27, 1995), dealing with dispositions of stock in domestic corporations by 10% foreign shareholders and limitations on treaty benefits. We believe the proposed provisions, which were added on the floor of the Senate without debate, raise many serious problems, some of which are outlined below.

Section 12882 of the bill would treat the gain or loss from the disposition of stock in a U.S. corporation by a foreignshareholder owning at least 10% of the stock of the corporationas income effectively connected with the conduct of a U.S. tradeor business, attributable to a U.S. permanent establishment and sourced in the United States, and would impose withholding requirements in connection with the disposition. Section 12883 of the bill would deny all treaty benefits to any

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foreign entity that is not a "qualified resident" of the treaty country, and would deny treaty benefits, even to a qualified resident, with respect to income that is subject to a special reduced tax rate in the foreign country.

A provision to tax gains realized by 10% foreign shareholders was first proposed, in a different form, as part of the Revenue Reconciliation Act of 1989. Both of the provisions in H.R. 2491 were subsequently incorporated, hi substantially the same form as now proposed, hi the Foreign Income Tax Rationalization and Simplification Bill of 1992 (H.R. 5270).Extensive hearings were conducted hi 1992 following introduction of the latter Bill. At the hearings, then Assistant Treasury Secretary for Tax Policy Fred Goldberg testified that the Treasury Department thought that the enactment of a provision taxing foreigners' stock gains was "undesirable" because (i) it would increase the cost of capital hi the U.S. by discouraging foreign investment, (ii) it would be complex to administer and difficult to enforce and (iii) it raised a variety of treaty concerns. Many of these concerns were also expressed by this Tax Section hi commenting on the 1989 Bill[1]

Mr. Goldberg also stated that the Treasury Department opposed a statutory limitation on treaty benefits because (i) it called into serious question the United States' willingness to abide by its tax treaty commitments and thus would invite retaliatory action from foreign countries that could undermine the competitiveness of U.S. multinationals, and (ii) it was.

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[1] The Tax Section commented on the 1989 proposal when it was first introduced. A copy of these comments is attached. For the most part, the points raised were not addressed in the 1992 proposal nor in the present Bill. Note, however, that under the 1989 proposal the imposition of tax on a foreign shareholder would have overridden conflicting treaty provisions; by contrast the present proposal (as did the 1992 proposal) contains no specific treaty override but limits the scope of all treaty benefits, as discussed herein.

unnecessary to further the policy objectives of the proposal given that qualified resident rules were being added to all new or renegotiated U.S. treaties. The Treasury Department's concerns with both provisions were echoed, in much stronger terms, in a letter sent by the embassies of eighteen of the major trading partners of the United States.

Since 1992, limitation on benefits provisions have been included in several additional income tax treaties, including those with Canada, Israel, Mexico and the Netherlands, sometimes after extended negotiations. For the United States to negotiate complex treaty provisions with our treaty partners and then unilaterally override them is wholly inappropriate and could seriously impair future treaty negotiations. Moreover, in view of these new treaty provisions the reasons to add to the Internal Revenue Code an across the board limitation on treaty benefits seem even less appealing than they did three years ago. In addition, the enactment in 1993 of Section 7701(1), limiting the use of conduits, has reduced the ability of foreign taxpayers to abuse our tax treaties.

We are also very concerned that the proposal to limit the treaty benefits which are available with respect to income taxed at reduced rates will introduce numerous uncertainties into the application of our tax treaties. While the principal target of the proposal in 1992 was apparently untaxed branch operations, the provision would have a far broader scope and its effects cannot be foreseen. For example, the provision would make the application of U.S. tax treaties turn on the details of foreign tax law, such as the means employed by foreign tax laws to avoid the double taxation of U.S. source income. We fear therefore that the legislation, if enacted, will introduce so many uncertainties into the application of tax treaties as to undermine their very purposes - avoidance of double taxation and encouragement of international trade and commerce. Finally, consideration must be given to the impact these rules would have on U.S. taxpayers, and to the U.S. revenue, if similar restrictions were adopted by our treaty partners.

In view of the substantial problems raised by these proposals, as a substantive matter we urge that they not be enacted. As a procedural matter, if further consideration is to be given to these proposals, we believe that the important developments since 1992 require that further hearings be held before these proposals become law. For these reasons, we think that the precipitous inclusion of these proposals, in H.R. 2491 is both unnecessary and unwise.

Should you or your staff wish to discuss this matter further, please do not hesitate to call me.

Very truly yours,

Identical letters have been sent to:

The Honorable Daniel P. Moynihan
United States Senate
Committee on Finance
464 Russell Senate Office Building
Washington, D.C. 20510

The Honorable Bill Archer
Chairman, Committee on Ways & Means
House of Representatives
1236 Longworth House Office Building
Washington, D.C. 20515

The Honorable Sam M. Gibbons
House of Representatives
Committee on Ways & Means
2204 Rayburn House Office Building
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Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
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Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Mr. Kenneth J. Kies
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20220

v. Disposition of Stock in Domestic Corporations by 10-Percent Foreign Shareholders

Section 11404 would add new Section 899, imposing tax on the disposition by a foreign shareholder of all or any part of a 10-percent or greater stock interest in a U.S. corporation.

Description of Measure

New Section 899 would provide that if any nonresident alien individual or foreign corporation is a "10-percent shareholder" in any U.S. corporation, any gain or loss from the disposition of any stock in such U.S. corporation would be taken into account as if effectively connected with a trade or business engaged in by the taxpayer in the United States. In addition, the proposal would adopt a withholding tax system whereby U.S. withholding agents would be required to deduct and withhold tax equal to 10 percent of the amount realized on the dispositions of the stock. New Section 899 would be generally effective for dispositions after December 31, 1989, with a delayed effective date of July 10, 1992 for certain beneficiaries of treaty countries.

Comments

We believe the proposed measure is unsound and should not be enacted. As in the case of the interest deduction disallowance rule of proposed Section 163(i), new Section 899 would significantly alter longstanding principles of U.S. tax law concerning the treatment of non-U.S. persons. Exemption from U.S. tax for gains and losses of non-U.S. persons has been part of the U.S. statutory regime for over 70 years. Moreover, the Foreign Investors Tax Act of 1966 actively encouraged foreign investment in U.S. stocks and securities. New Section 899 would, nevertheless, retroactively (in relation to their investment commitment) impose U.S. tax on foreign investors who relied in good faith on such clearly articulated U.S. policies. Especially in light of the fundamental change this measure would make in the longstanding U.S. tax treatment of foreign persons, we think the proposed measure should not be adopted in the absence of a compelling tax or other policy justification to do so. We are aware of no policy justification that would support this measure.

The proposed measure would contradict, albeit on a deferred basis, policies underlying provisions of the 1981 U.S. Model Income Tax Treaty, the 1977 OECD Model Income Tax Treaty

and several tax treaties that the U.S. has entered into with. 1 foreign governments. It seems apparent that actions on the part of the United States which have the effect of abrogating our treaty responsibilities should be undertaken only if they are in furtherance of policy objectives that will outweigh the damage to our international relations that can be expected to arise from such unilateral conduct. As far as we have been able to determine, there are no overriding policy objectives that could justify the negative impact that adoption of this proposal would likely have on our relations with foreign treaty partners. Moreover, in pure monetary terms, the likely retaliatory response by our treaty partners, by itself, should eliminate any benefit from the de minimis revenue estimates

Even where a foreign buyer does wish to dispose of part of its economic interest in a U.S. business, the effectiveness and consequences of the provision will be subject to question. A well-advised foreign parent with the benefit of a tax treaty will frequently find it advisable first to cause the U.S. subsidiary to borrow and distribute to it an amount up to the sum of the maximum dividend payable for U.S. tax purposes (whatever earnings and profits restrictions will allow) plus

its unrecovered original investment[2]. In due course, the borrowing can be paid off by a new issuance of stock by the U.S. subsidiary. No foreign parent need subject itself to the capital gains tax, therefore, unless it wishes to withdraw more than the sum of its investment plus the earnings of the business. If it wishes to sell out to a foreign purchaser, it is likely to have more flexibility in structuring such a transfer free of U.S tax than it would in selling to a U.S. purchaser. The heaviest burden thus is likely to fall on a sale to a U.S. purchaser.

If a purpose of the proposal is to discourage foreign acquisitions of U.S. corporations, it should b understood that this change will discourage few if any foreign takeovers of American corporations. Typically, foreign takeovers of U.S. target corporations are accomplished by purchasing the parent company of an operating group. The foreign purchaser is usually an operating company intent on securing ownership of one

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31 The net United states tax realization thus would be as little as 5% of the amount taxable as a dividend. The distribution may not attract tax in the foreign parent's home country, for example, because the foreign country gives double taxation relief through exemption of dividends or a Section 902-type indirect foreign tax credit, or because the distribution is not treated as a dividend if nominally effected as a stock redemption (even though pro rata).
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or more businesses operated by the*U.S. target corporation, if :I the takeover is successful, the foreign buyer then proceeds to cause the U.S. target corporation to sell those lines of business which the foreign corporation cannot integrate with its basic foreign business, and the proceeds of those sales are then used to pay down debt incurred in the acquisition. The gains arising from the sales of these "non-core" businesses have, since General utilities repeal, been fully subject to U.S. tax. New Section 899 would not impose any additional tax on those gains. When all is done, the foreign buyer owns the target U.S. corporation with its core businesses which it proceeds to operate and integrate with its foreign business. It is generally not the plan, in most of these situations to then dispose of the stock of the U.S. target. Thus it is very unlikely that new Section 899 would produce any change in the pattern of foreign takeovers of U.S. businesses.

The proposed measure is also objectionable from the perspective of the complexity the measure will engender and the extreme difficulty (and expense) the IRS is likely to encounter in attempting to administer it. He believe that it is essential that Congress, prior to enacting an extremely complex proposal such as Section 899, first balance the policy objectives of the legislation against the negative aspects of

increased complexity and the burdens of administering the new rules. While we recognize that occasions arise when it is necessary to adopt complex rules, those cases should be limited to situations where overriding policy objectives will be served. It is difficult to imagine how such a balancing, if performed in connection with new Section 899, could justify its enactment.

A listing of our more particular concerns with the measure as drafted follows:

1. The statute should make clear that, as is currently true with the FIRPTX tax, taxable gain under new Section 899 will not be subject to the branch profits tax. Cf. Section 884(d)(2)(C).

2. Proposed Section 899(e)(2) should refer to convertible debt rather than "the conversion feature" of a debt obligation. Otherwise, there will be uncertainty in treatment of a convertible debt obligation sold at a gain, some of which arises from a drop in prevailing interest rates. If, as in subsection (e)(3), any other interest not held solely as a creditor is treated as stock, there is no reason why a convertible debt obligation as such should not also be so treated.

3. A more important and difficult problem involves the application of the vote and value percentages to options and convertible securities. Presumably, ownership of the option or security should be treated as ownership of the voting power that would be possessed if the option or conversion right were exercised, as is the case<under Section 318. Would options and convertibles (if the definition is changed as suggested above) be valued as if they were stock without any consideration being given to their other attributes? The statute probably compels that result and it seems desirable. The most difficult problem is what: to do with options and convertible securities held by other persons. The uncertainty in this area under Section 318[3] may be acceptable where the only question is a determination of the liability for tax of the person making the determination (who, in general, may be presumed to have adequate knowledge of the facts), but it becomes intolerable when the issue is faced by a withholding agent who could be penalized if he makes the wrong decision. Although the withholding provisions are not to apply for six months after enactment of the legislation, it is unclear whether the Service will be able to issue guidance on these issues in that period of

32 Cf. Rev. Rul. 68-601, 1968-2 C.B. 126 and Sorem v. Commissioner. 334 F.2d 275 (10th Cir. 1964).

time and, indeed, withholding agents will be required to put a withholding process in place before that date. Therefore, guidance on these subjects and the statute or legislative history is essential.

4. The phrase "or have reason to know" in proposed Section 1447(b)(2)(A) should be deleted, where stock is traded on a securities market, particularly on a stock exchange, a broker will normally be an unrelated third party who is not willing to run any risk of being subjected to penalty for failure to collect a withholding tax especially since the phrase "or have reason to know* is open to varying interpretations. Thus, we are concerned that such a requirement will have substantial adverse effects on the orderly trading process. In the information reporting area, Treas. Reg. S35a.9999-5 Q&A 2 provides that there is no information reporting, unless the issuer or its agent has actual .knowledge that a payee is a United States person. A similar standard should apply here.

5. The exception to the regularly traded rule in proposed Section 899(b)(2)(B) for separate dispositions of 1% or more of the stock of a corporation would presumably make the affidavit requirement for non-publicly traded stock applicable, whether the dispositions are by U.S. persons or by foreign

persons. The provision raises a question as to whether and to what extent different trades are to be treated as a single "disposition* for purposes of this rule. What if 1% of the stock of X Corporation is represented by 100,000 shares and a shareholder sells 20,000 shares in the morning of day I, 40,000 shares that afternoon and 50,000 shares the next day? If the seller uses the same broker for all three trades, how does this provision apply, if at all?

6. We fail to see the reason for the requirement in proposed Section 1447(b)(2)(C) that any time Section 899 applies to a disposition by a foreign person of regularly traded stock, that person will notify the withholding agent that Section 899 applies. The statute should be modified to provide (i) that no such notification is required if the sale represents less than 1% of the issuer's stock, and (ii) that the withholding agent shall have no liability for failure to withhold if such notification is not provided to it (unless it has actual knowledge that withholding was required).

7. Either the statute or its legislative history should provide a definition of "established securities market."See proposed Section 897(d)(3). The FIRPTA definition in Treas. Reg. SI.897-1(m) would appear appropriate here.

8. Having established 10% as the ownership threshold for taxing foreign shareholders' gain, the proposed measure would include a novel attribution rule (new Section 899(c)(3)) inconsistent with this principle, under which a foreign holder of an interest in a partnership would be treated as a person owning 10% or more of the shares of a U.S. corporation, if the partnership owns 10% or more of the shares in that corporation. The result of this approach would be to extend the scope of the proposal to situations well beyond its apparently-intended application. For example, under this partnership attribution rule, a 1% limited partner.(who has no control over the identity of the other partners, the investment decisions of the general partner or the actions of the partnership as a shareholder) would be treated as a "10% shareholder" if the partnership owns 10% of the issuing corporation, even though such limited partner's beneficial interest in the issuing corporation would only be 1/10th of 1%. This novel attribution rule has the potential to create extraordinary uncertainty and complexity. The proposal would put additional pressure on the difficult question of when an arrangement (such as a co-investment contract or investment management contract) constitutes a partnership. There would also be substantial factual disputes in determining whether a common investment by several individual

accounts with common management should be viewed as a partnership. we recommend that the special partnership attribution rule be eliminated from the. proposal. Allowing the. Normal attribution rules of Section 318 to govern.

9. Proposed Section 1447 contains no provision similar to Code. Section 1445(c) permitting the, amount of the, withholding to be reduced to the amount of the, transfer's maximum tax liability. Accordingly. withholding, would be required even if the transferor is selling the, stock at a loss. We suggest that the words "section 1445 (c) and' be added to proposed section 1447(d)(5) immediately, before the reference to •section 1445(e)."