**REPORT #884**

## TAX SECTION

# New York State Bar Association

Report on Proposed Withholding Tax Regulations

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**TAX SECTION**

# New York State Bar Association



September 27, 1996

Hon. Donald C. Lubick
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re : Report on Proposed Withholding Tax Regulations

Dear Secretary Lubick and Commissioner Richardson:

I am pleased to submit the enclosed report on the withholding tax regulations that were proposed in April.

We believe that the proposed regulations represent an important and extremely useful effort to Devise the withholding tax rules and we commend the Internal Revenue Service and Treasury for this initiative. We have, however, a number of comments on the proposed regulations. These are summarized on pages 1-5 of the report.

Please let me know if we can be of any further assistance. If it would be useful, we would be pleased to meet with the Internal

Revenue Service and the Treasury to discuss our comments.

Respectfully submitted,

Richard L. Reinhold
Chair

[Enclosure]

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September 27, 1996

# Report on Proposed Withholding Tax Regulations

This report, prepared by an ad hoc committee of the Tax Section,[1]/ comments on the proposed regulations relating to the withholding of tax under Sections 1441 and 1442 that were published on April 22, 1996 (the "Proposed Regulations")[2]/

## I. Introduction and summary of comments.

The Proposed Regulations represent a comprehensive and extremely useful proposal to revise the present withholding tax rules. We have limited our comments to what we perceive as the principal features of the Proposed Regulations and certain related matters. In summary of what is set out below:

(1) We support the elimination of the "address rule" for dividends and the requirement that a Form W-8 be provided to substantiate a foreign shareholder's entitlement to a reduced rate of withholding on dividends.

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[1]/ Chaired by Willard B. Taylor and Charles M. Morgan, III and consisting of Richard Andersen, Janet Andolina, Matt Blum, Douglas Borisky, Shlomo Cohen, Samuel J. Dimon, Stephen Douglas, Daniel M. Dunn, Michael Barber, Pinchas Mendelson, David S. Miller, John Narducci, Richard o. Loengard, Jr., Sharon Silver, Nicole Tanguy, Lewis Tepper and Lawrence Witdorchic. Helpful comments were received from Peter C. Canellos, John A. Corry, Stephen B. Land, William B. Brannan, William Burke, Sherwin Kamin, Yaron Z. Reich, Richard L. Reinhold, Michael L. Schler and Isaac Sonsino.

[2]/ 61 Fed. Reg. 17614 (April 22, 1996).

(2) We question whether it is useful to apply the qualified intermediary procedure to interest on registered form debt, and suggest that it should be sufficient if a foreign financial institution that holds such obligations on behalf of customers represents to the U.S. withholding agent that it does so on behalf of customers who are not United States persons. This might be policed by permitting certification only by financial institutions which have acceptable know-your-customer rules.

(3) Unless the Treasury and other Government issuers intend to make use of the special rules for so-called “targeted registered obligations”, we see no reason to continue those rules. It is our understanding, however, that Government-sponsored enterprises, such as the Student Loan Marketing Association, have continued to make use of the rules and we see no reason to eliminate the rules for targeted registered form obligations if that is the case. We also recommend that the Internal Revenue Service revisit the rule that precludes certain U.S. Government “owned” or “sponsored” enterprises from issuing bearer form obligations and its 1984 announcement that would extend that rule to U.S. Government-backed securities.

(4) The rule that permits a U.S. withholding agent to accept a Form W-8 without a TIN in the case of interest on registered form portfolio debt and dividends on shares of stock that are traded on a U.S. established securities market should be expanded to include shares of open-end investment companies. Consideration should be given to extending the rule to other capital markets instruments, such as debt issued on or before the July 18, 1984 repeal of the withholding tax on portfolio interest.

(5) The proposed rules with respect to withholding on original issue discount are confusing, and we recommend that they be revised and reissued in proposed form.

(6) In the case of dividends and other income subject to a reduction or exemption under a tax treaty, the qualified intermediary procedure will be useful only if the Internal Revenue Service agrees to restrict its authority to audit -- for example, by limiting audits to the financial institution's procedures, not the accuracy of beneficial owner information. With respect to the information that must be collected by a qualified intermediary, we believe that it should always be sufficient if the qualified intermediary has in place procedures to obtain the equivalent of a Form W-8.

(7) We support the issuance of comprehensive rules for income from notional principal contracts, but suggest that there be no general requirement that a foreign counterparty provide a Form W-8 and question the imposition of backup withholding on income paid on notional principal contracts.

(8) While many of us are sympathetic to the policy behind the proposed look through rule for foreign partnerships, we conclude that, in the absence of clear authority, this change should be made by revisions to tax treaties or an amendment to Section 702(b) of the Internal Revenue Code. There would not be a question of authority if the change was limited to withholding and did not affect underlying tax liabilities, but we think it is unwise to decouple the obligation to withhold on income from the recipient's tax liability. We also think that requiring Forms W-8

from partners of a foreign partnership that receives interest on registered form debt obligations owned by the partnership serves no useful purpose.

(9) We generally support the proposed rules with respect to domestic partnerships. For the reasons set out in (8) above, the rules proposed for foreign partnerships should be extended to domestic partnerships, if at all, only by revisions to tax treaties or an amendment to the Internal Revenue Code.

(10) We recommend revisions to the rules with respect to domestic and foreign fiduciaries, including the possible extension to foreign fiduciaries of any look through rule that is ultimately adopted for foreign partnerships.

(11) We have a number of comments on the rules with respect to bearer form obligations, including the suggestion that the $500,000 minimum denomination requirement for short-term bearer obligations be eliminated.

(12) We support in principle the decision to provide a single, coordinated set of procedures for all withholding certificates. Combining all exemption certificates into a single document in the manner contemplated by the Proposed Regulations, however, is likely to be difficult to implement and we recommend that the Service simply unify the rules and procedures relating to exemption certificates without combining the forms into a Form W-8.

(13) We do not think it appropriate to require withholding on the gross amount of “stated interest”, in cases

where part of this amount is not interest income for Federal income tax purposes, or in general to require withholding on amounts that are not income.

(14) We have a number of recommendations with respect to information reporting and backup withholding, including that (a) reporting obligations not be imposed on non-U.S. payors and middlemen, (b) with revisions, the “eyeball” test for payments to corporations be retained, and (c) the list of international organizations set out in the current regulations not be eliminated.

(15) We recommend that Prop. Regs. § 1.871-14 (b) (2), which reserves on the treatment for TEFRA purposes of registered form obligations that may be converted into bearer form obligations, treat such obligations as registered form obligations if conversion may only occur in the manner described in our report.

(16) We recommend a number of technical changes to the Regulations under Section 165 (j), relating to the disallowance of losses in respect of bearer form obligations and also to the rules regarding the portfolio interest exemption for interest paid on bearer form obligations.

II. Withholding with respect of dividends on traded shares.

The Proposed Regulations eliminate the so-called address rule, which entitles a withholding agent to assume that U.S. source dividends paid to a foreign address are paid to a resident of the country of the address, and, in the case of dividends on certain traded shares, provide that a withholding agent may rely on a Form W-8, without a taxpayer identification number, to determine eligibility for a tax treaty reduction in the 30% withholding tax.[3]/ The Form W-8 may be provided by the beneficial owner or a qualified intermediary on behalf of the beneficial owner.[4]/ Other U.S. source dividends are subject to the general rule for treaty income that requires the beneficial owner to obtain and provide a taxpayer identification number on the Form W-8 provided to the withholding agent.[5]

We think the elimination of the address rule is a sensible change. That rule provides little or no assurance that the recipient of a dividend is a resident of the treaty country, and in allowing withholding agents to assume that this is the case, U.S. withholding tax rules are clearly out of line with what is required by other countries. We also believe that it is appropriate to require a Form W-8, either from the beneficial owner or a qualified intermediary, in the case of publicly-traded shares, since there should be some affirmative evidence of treaty residence in order to provide treaty benefits.

Under the Proposed Regulations, the Form W-8 need not include a TIN, if the dividends are paid on shares that are traded on a “U.S. established financial market”. The definition of publicly-traded ought to be expanded to include shares of an open-end investment company. These will not be included by the

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3/ Prop. Regs. § 1.1441-6(b)(2).

4/ Or, as noted, there may be special tax treaty rules.

5/ Prop. Regs. § 1.1441-6(b)(1).

definition the Proposed Regulations, since it is limited to shares traded on a national securities exchange that is registered under the Securities Exchange Act of 1934 or an interdealer quotation system sponsored by a national securities association registered under the Securities Exchange Act of 1934.

III. Withholding in respect of interest on registered form portfolio debt.

The Proposed Regulations modify the rule that applies to interest on registered form debt of a U.S. issuer that is "portfolio interest" to provide that the required Form W-8 may be provided by a "qualified intermediary", as well as by the beneficial owner of the obligation.[6]/ As discussed below, however, a financial institution or other person may qualify as a qualified intermediary only by entering into an individually-negotiated agreement with the Service that will require it to obtain beneficial owner documentation from its customers and subject the procedures it follows in collecting this information to Internal Revenue Service audit.[7]/

As we understand the qualified intermediary procedure, it is an attempt to balance the need for appropriate rules to determine eligibility for reductions in the U.S. withholding tax with the concern that the rules not discourage foreign investment in publicly-traded securities of U.S. issuers.

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[6]/ Prop. Regs. §§ 1441-l(e)(1) and (3). In addition, the Proposed Regulations contemplate that there may be special arrangements pursuant to tax treaties.

[7]/ See VII. Withholding in respect of interest, dividends and other income paid to "qualified intermediaries".

We question whether it is useful to apply the qualified intermediary procedure to interest on registered form portfolio debt that would otherwise be "portfolio" interest. The alternative is to permit a withholding agent to accept the representation of a bank, clearing organization or other financial institution that it holds the debt on behalf of a customer who is not a United States person, and thus not require the financial institution to become a qualified intermediary for this purpose. Guidelines could be published by the Internal Revenue Service with respect to acceptable "know-your-customer" rules, and financial institutions that did not have such rules could be denied the right to certify on behalf of customers.

Since interest on registered form debt that is otherwise portfolio indebtedness is free of U.S. withholding tax if paid to any foreign beneficial owner, the sole purpose of requiring beneficial owner documentation is to guard against the possibility that interest paid to a foreign person is in fact paid to a United States person who will not declare the interest as income. We doubt that such a narrow target justifies a system that requires universal beneficial owner documentation. Requiring banks, securities firms and others that hold securities for customers to become qualified intermediaries in order to deliver Forms W-8 in respect of interest on registered form debt does not seem to us to be appropriate, given the ease with which any United States person who is determined to avoid U.S. tax on U.S. source interest on registered form debt can avoid the withholding rules by holding such obligations through a foreign entity classified as a corporation. There is statutory authority to deal with unreliable certifications.[8]/ Moreover, U.S. taxpayers that

[8]/ Section 871(h)(4), last sentence, which authorizes the Internal Revenue Service to determine that statements of beneficial ownership from any person, or class of persons, may not be relied on.

are determined to avoid U.S. taxation on interest income are unlikely to purchase registered form debt of U.S. issuers to accomplish that objective when other instruments -- including bearer form debt and registered form debt of non-U.S. issuers -- do not require a Form W-8.

A statement from the beneficial owner of a registered form obligation is not required by Section 871(h)(2)(B) of the Code, which simply requires a statement that the beneficial owner is not a U.S. person. The legislative history of Section 871(h)(2)(B) bolsters the view that this is all that is required,[9] and the statute plainly contemplates that statements of beneficial ownership will be delivered by persons other than the beneficial owner.[10]/

IV. Targeted registered obligations.

The preamble to the Proposed Regulations asks for comments on the desirability of continuing the rules that relax the beneficial owner documentation required in connection with interest paid on so-called targeted registered obligations[11]/

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[9]/ See Joint Committee Print, Tax Treatment of Interest Paid to Foreign Investors (Including H.R. 3025 and H.R. 4029) (April 28, 1984), JCS-23-84, stating, in its description of the identical language of H.R. 3025, that “the statement [from a financial institution] would not have to identify the owner, but simply to state that the owner was not a U.S. person”.

[10]/ Thus, Section 871(h) (4), last sentence, is directed at the possibility that statements from a bank or other person holding securities for customers will prove unreliable.

[11]/ Stating that “because these special procedures have been rarely used, comments are solicited on their usefulness and whether they should be retained”.

The different rules for targeted registered obligations were originally intended to accommodate U.S. issuers, such as the Treasury and U.S. government "sponsored enterprises" or U.S. Government-owned "agencies", which are precluded from issuing bearer form obligations in foreign capital markets.[12]/ They provide only a marginal relaxation of the beneficial owner documentation rules,[13] and we see no reason to retain the rules if they are not being used by those issuers. It is our understanding, however, that these rules are still used by some enterprises or agencies, such as the Student Loan Marketing Association; and, if that is so, we see no reason to eliminate the rules for targeted registered form obligations.

We note that the Regulations that deny U.S. Government "sponsored enterprises" and U.S. Government-owned "agencies" the ability to issue bearer form obligations have remained essentially unchanged since they were issued more than 10 years ago, notwithstanding that the ownership and management structure of some of the agencies or enterprises listed in the Regulations have changed, and that the Internal Revenue Service and Treasury Service have never issued the promised guidance on its announcement that "U.S. Government-backed securities" issued after September 7, 1984 are not eligible to be issued in bearer form.[14] It might be useful to re-consider what entities are

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12/ See Treas. Regs. § 1.163-5 (c) (1), which sets out the prohibition. See also Treasury News Release (September 7, 1984) threatening an extension of this rule to securities backed by such obligations.

13/ The Regulations in substance permit a foreign financial institution to certify that an obligation held for a customer is not beneficially owned by a United States person. Treas. Regs. § 35a.9999-5(b), Q & A 12-15.

14/ Treasury News Release (September 7, 1984).

Government “owned” or “sponsored”, and we do recommend that the Service either act on, or formally withdraw, the 1984 announcement with respect to “U.S. Government-backed securities”.

V. Other capital markets instruments.

The apparent principle underlying the treatment of portfolio interest on registered form debt and dividends paid on traded shares is that a TIN should not be required where the instrument is one that is ordinarily issued in capital markets to unrelated persons. If that is correct, consideration might be given to extending the principle to (1) interest on registered form debt which, but for being issued on or prior to July 18, 1984, would be portfolio indebtedness, (2) interest on instruments, such as “repos” that are commonly issued to banks and thus, if having a maturity of more than 183 days, would not be excluded by the exclusion for original issue discount on short term instruments and may not be portfolio interest because of the exclusion of interest on certain bank loans, and (3) interests in publicly-traded trusts that hold instruments or assets that would otherwise not qualify for the rule.[15]/

VI. Original issue discount.

Regulations were proposed in 1976 with respect to withholding on original issue discount.[16]/ These were widely-

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[15]/ This would have limited relevance to royalty trusts since oil, gas and other mineral royalties are ordinarily subject to a 30% withholding tax. It may, however, affect other fixed-investment trusts, including those licensing intangible property.

[16]/ 41 Fed. Reg. 28517 (July 12, 1976).

criticized, in part because they required withholding by purchasers in the secondary market, and were never adopted.

With the issuance of the Proposed Regulations, the 1976 proposed Regulations were withdrawn; and, according to the preamble, the Proposed Regulations are intended to limit withholding to "transactions in which information about the amount of original issue discount would generally be known or available to the withholding agent". While the Proposed Regulations do eliminate important objections to the 1976 Proposed Regulations, the rules in the Proposed Regulations with respect to withholding on original issue discount are unclear and in some respects confused. The importance of the issues is, of course, diminished by the 1984 repeal of the withholding tax on portfolio interest, but we nonetheless think it important that the rules be workable. We therefore recommend that this part of the Proposed Regulations be revised to reflect the concerns which are set out below, and reissued in proposed form.

As we understand the Proposed Regulations, they provide for withholding in respect of original issue discount in essentially five cases:[17]/

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[17]/ Prop. Regs. § 1.1441-2(b)(3).

We note that the original issue discount rules assume, as would be expected, that withholding would apply only to actual payments such as in the case of maturity or retirement or the other cases described in the text, but not on the mere accrual of original issue discount income (see, Prop. Reg. §§ 1.1441-2(b)(3)("[o]nly the original issue discount described in this paragraph (b)(3) may be subject to withholding."), 1.1441-2 (b) (3) (i) to (v) (each describing "amounts paid" on obligations)). Prop. Reg. § 1.1441-(2)(e), however, provides that for purposes of the withholding rules a "payment" would be "considered made when the amount would be includible in the income of the beneficial owner under the U.S. tax principles governing the cash basis method of accounting." That implies that withholding would apply to "deemed" income items that are includible in income without any actual payment such as original issue discount or certain income arising under Section 305. We believe that this result is not intended and, accordingly, Prop. Reg. § 1.1441- 2(e) should be clarified.

(1) out of any payment made by the issuer on the maturity or retirement of a debt obligation;

(2) out of the payment made by a purchaser to a related seller of a debt obligation;[18]/

(3) out of any payment made by a purchaser of a debt obligation if the purchaser[19]/ has actual knowledge of the amount of original issue discount subject to tax under Section 871 or 881;

(4) out of any payment made on a debt obligation if the issuer of the obligation has actual knowledge of the amount of original issue discount subject to tax under Section 871 or 881; and

(5) out of any payment of interest made on a debt obligation if the original issue discount fails to qualify as portfolio interest because of the absence of beneficial owner documentation.[20]/

The first rule applies to any obligation issued after March 31, 1972; the others only to obligations issued 60 days after the adoption of the Proposed Regulations as final Regulations.

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[18]/ A person is related for the purposes of these rules if the person is related within the meaning of Section 163(e) (3), which in turn refers to Section 267(b).

[19]/ The Proposed Regulations in fact provide for withholding in such a case if the "seller" has actual knowledge, but we assume that this is an error. Prop. Regs. § 1.1441-2 (b) (3) (iv).

[20]/ Prop. Regs. § 1.1441-2(b)(3). Withholding is also required, by Prop. Regs. § 1.1441-2(b) (3)(ii), in respect of amounts paid by an obligor on obligations originally issued by a related obligor.

We have the following comments:

1. The obligation to withhold is in each case stated to be only “to the extent that the amount is subject to tax under section 871(a) (1) (C) or under section 881(a) (3)”. It will, of course, be difficult, if not impossible, for a person obligated to withhold to know whether that is the case if the obligation is transferable and may have been held by United States persons or by foreign persons not subject to tax under those sections. It would obviously be desirable to provide presumptions regarding the ownership of the obligations, particularly because issuers appear to be required by the Proposed Regulations to determine the amount of each holder's tax liability.[21]/

2. Although the statute sets out a pecking order for imposing withholding tax on original issue discount,[22] there is no coordination among the rules in the Regulations -- thus, for example, the first rule appears to require withholding at maturity or payment in respect of the entire amount of original issue discount, notwithstanding that some of the original issue discount may have been subject to withholding under the fifth rule at the time that interest was paid. The Proposed Regulations lack a rule that will relieve a person who is obligated to withhold from the obligation to withhold on amounts that have already been subject to withholding. The fact that an issuer may adjust for overwithholding under Regs. § 1.1461-2 or that a

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[21]/ The presumption in the fifth rule appears to be limited to the determination of income, not ownership of the obligation.

[22]/ Section 871(a) (1) (C) (i), which requires withholding in the case of a sale only to the extent that the original issue discount was not previously taken into account by withholding from interest; and Section 871(a) (1) (C), which requires withholding in the case of a payment by the issuer only to the extent the original issue discount was not previously taken into account in withholding by the issuer.

holder may seek a refund for overwithholding is not an adequate response, particularly in light of the requirement that a foreign person seeking a refund obtain a TIN.

This problem may be illustrated in any number of examples. Assume that a corporation issues interest-bearing obligations at a discount and withholds in respect of the discount out of interest payments under the fourth or the fifth rule; it would seem that there must also be withholding at maturity under the first rule, without any allowance for the prior withholdings. Or assume that a corporation issues a non-interest bearing obligation which is purchased and then sold by a foreign person who, having knowledge of the actual amount of original issue discount, withholds under the third rule; again, it would appear that withholding may be required on the same amount by the issuer at the maturity of the obligation.

In some cases it may be possible to avoid duplicative withholding simply by coordinating the rules (i.e., by providing that an issuer is not required to withhold under the first rule in respect of any amount on which it had previously withheld under the fourth or the fifth rule). In other cases, consideration might be given to permitting certification by holders to purchasers or to the issuer. Other parts of the Proposed Regulations (e.g., Prop. Regs. § 1.1441-3 (d), relating to certain gains) contemplate such certifications.

3. The third rule requires any purchaser of an obligation to withhold in respect of original issue discount if the purchaser has “actual knowledge of the amount subject to tax under” Section 871 or 881. If this rule has a justification,

it is to deal with a case in which, before a payment that would be subject to the first or the fourth rule, a foreign holder sells an original issue discount obligation to an unrelated U.S. or foreign person in order to avoid withholding. It seems to us that it should be written so that it is directed at such abusive cases. (An analogy might be the anti-abuse rule in Prop. Regs. § 1.1441-3(b)(ii).) As the third rule is now written, it is so narrow -- absent knowledge of the precise amount that is subject to tax, there is no withholding obligation -- that it may well not apply in such a case.

If the rule is retained, it should be revised to clarify that the listing of an obligation in Service Publication 1212 is not sufficient to trigger this withholding responsibility. For the reasons discussed above, the information in Publication 1212 will not be sufficient to provide a payor with all the information it needs to determine the amount of OID that is taxable to a particular payee. However, it would be helpful if the regulations confirmed this.

4. The fourth rule requires withholding by an issuer if the issuer has actual knowledge of the amount subject to tax under Sections 871 or 881. What this apparently adds to the first and fifth rules is a requirement that an issuer withhold in respect of original issue discount from interest payments in a case where the debt obligation is not portfolio indebtedness for a reason other than the failure to furnish the beneficial owner statement (e.g., the holder is a 10% or greater shareholder of the issuer). That this is the scope of the rule could usefully be clarified.

5. The first rule states that it applies only to original issue discount and therefore not market discount.[23]/ This is so for all of the rules and the statement, if retained, should therefore be made to apply to all of the rules.

## VII. Withholding in respect of interest, dividends and other income paid to "qualified intermediaries".

As set out above, in the case of interest on registered form portfolio debt, dividends on publicly-traded shares and certain other income-producing assets held through a qualified intermediary, a withholding agent may rely on a Form W-8 provided by the qualified intermediary, as well as a Form W-8 provided by the beneficial owner, and the Form W-8 need not in such a case include the beneficial owner's TIN.

The main purpose of the qualified intermediary rules, as we understand them, is to permit banks and other financial institutions to act for their customers in withholding tax matters. The Proposed Regulations attempt to strike a balance between the need for appropriate withholding tax rules and the concern that those rules not deter foreign investment in publicly-held securities of U.S. issuers.

A qualified intermediary is a financial institution or other specified person who has entered into a withholding agreement with the Service. The Proposed Regulations set out the general terms of the agreements, and, simultaneously with the issuance of the Proposed Regulations, the Service issued a draft

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[23]/ Prop. Regs. § 1.1441-2 (b) (3) (i), last two sentence.

Revenue Procedure with respect to the procedures for qualification.[24]

As set forth above (see III. Withholding in respect of interest on registered form portfolio debt), we question whether the qualified intermediary procedure should be applied to interest on registered form portfolio debt. In our judgment, it ought to be sufficient for the bank or other financial institution to represent to the withholding agent that the interest is received for customers who are not U.S. persons.

In the case of dividends paid on traded shares and other income subject to a treaty reduction or exemption, the qualified intermediary procedure may or may not be useful, depending on how it is implemented. We have set forth below a few basic principles that should guide the implementation of the qualified intermediary procedures. While we believe that these principles are consistent with the Proposed Regulations and Announcement 96-23, it would be helpful if the Service confirmed its intent to follow these principles.

1. For the procedure to be useful, the agreement will have to include limits on the scope of the Internal Revenue Service's audit authority. If there are no such limits, it will serve no useful purpose for a foreign bank or other financial institution to enter into such an agreement -- it could achieve the same result, without the cost and complexity of applying for and negotiating the agreement, by holding customers' securities in a domestic entity and administering the withholding itself. To be sure, that entity's compliance with the withholding tax rules

[24] Prop. Regs. § 1.1441-1(e)(5) and the proposed Revenue Procedure set out in Announcement 96-23, 1996-18 I.R.B. 7 (April 26, 1996).

would then be subject to Internal Revenue Service audit, but that would be no disadvantage unless qualification as a qualified intermediary would meaningfully reduce the scope of the audit.

One possibility would be to ordinarily limit audits to the procedures used by the qualified intermediary to obtain Internal Revenue Service beneficial owner documentation and its compliance with those procedures, not the accuracy of the information -- this is apparently what the Proposed Regulations have in mind when the state that, in appropriate circumstances, the Internal Revenue Service may agree to rely on audits by an intermediary's external auditors.[25]/

2. A financial institution or other person ought not to be required to agree to obtain more documentation from its customers than would be required by a U.S. withholding agent -- *i*.*e*., it should always be sufficient if the qualified intermediary has in place procedures pursuant to which it will obtain the equivalent of a Form W-8 from its customers, even though it may in fact collect more reliable information (such as passports or national identity cards). This seems to us to be only logical.

3. Institutions should know what to expect when applying to the Internal Revenue Service, and it would therefore be desirable for the Internal Revenue Service to develop, and make public, a form of agreement or of standard clauses in such an agreement. It is important that the terms of these agreements do not become a source of private law.

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[25]/ Prop. Regs. § 1.1441-1 (e)(5)(ii)(B)

VIII. Withholding in respect of income from notional principal contracts.

A. Current law.

1. Withholding Tax. Under current regulations, income from a notional principal contract is generally sourced by reference to the residence of the payee.[26]/ Accordingly, no withholding is generally required on notional principal contract payments to a foreign counterparty unless the notional principal contract is income of the payee that is effectively connected with a U.S. trade or business (in which case a Form 4224 is required to be supplied by the payee to avoid withholding).

2. Information reporting and backup withholding. It is far less clear whether information reporting and backup withholding is required in respect of notional principal contract income. On the one hand, if notional principal contract income is considered “fixed and determinable ... gains, profits or income”,[27]/ backup withholding would appear generally to be required unless (i) the income is effectively connected and the payor has received a Form 4224 from the payee, (ii) the payor can conclude that the payee is a corporation or (iii) the payor has received a Form W-9 from the payee. Under this view, backup withholding would appear to be required on notional principal

[26]/ Treas. Regs. § 1.863-7(b)(1). Notional principal contract income that arises from the conduct of the payee's trade or business within the United States (“effectively connected income”) is sourced in the United States. Treas. Regs. § 1.863-7(b)(3).

[27]/ The Internal Revenue Service has declined to answer this question. See Notice 87-4, 1987-1 C.B. 416.

contract income paid to a foreign non-corporate party, even if the payor has received a Form W-8.[28]

[28] The regulatory road to this conclusion is unusually circuitous but flows from the fact that, because notional principal contract income is not dividends, a liquidating distribution, interest or brokerage proceeds, it is apparently subject to section 6041 information reporting, which does not contain an exception for payments to foreign persons.

Section 6041 (information at the source) applies, in general, to every person engaged in a trade or business that makes a payment of $600 or more of fixed or determinable gains, profits or income that is not interest, liquidating distributions, dividends, or relates to brokers' transactions. See Treas. Regs. § 1.6041-1(a)(1). Exceptions from section 6041 information reporting exist if (i) the payment is required to be reported on Forms 1042, 1042S, 1000, 1001, 1120, 1120-S, 941, W-3 or W-2, (ii) the payment is made to a corporation (other than certain hospitals or extended care facilities), or (iii) the payment is of certain types of income that do not include notional principal contract income. See Treas. Regs. § 1.6041-3(a)-(p). None of these exceptions include payments to foreign persons. In general, backup withholding is required of payments reportable under section 6041. Treas. Regs § 35a.9999-2, Q&A-10; Treas. Regs. § 35a.9999-3, Q&A-13.

Since effectively connected income is reported on Form 1042, no backup withholding is required in respect of such income. However, notional principal contract income is not normally required to be reported on any other form listed in Treas. Regs. § 1.6041-3(a). Non-effectively connected notional principal contract payments made to foreign persons are not reported on Form 1042 because such payments are foreign source and, as a result, are neither (i) specified in Treas. Regs. § 1.1441-2 (which specifies that only U.S. source income is subject to withholding) or (ii) entitled to a specific complete or partial exemption from withholding. See Treas. Regs. §§ 1.1461-2(b) and (c), and 1.1441-2. In contrast to portfolio interest or effectively connected income, for which withholding is not required under a specific exemption, non-effectively connected foreign source income is not entitled to an exemption from withholding because it is not subject to U.S. withholding tax in the first instance.

Regulations under section 3406 also exempt from backup withholding payments made to a tax-exempt organization, the United States or a State thereof, a foreign government or political subdivision (or agency or instrumentality thereof), or a foreign central bank of issue. Treas. Regs. § 35a.9999-3, Q&A 13. This list similarly does not include foreign persons generally.

Regulations confirm that "exempt recipients" that are subject to information reporting under section 6041 are subject to backup withholding. See Treas. Regs. § 35a.9999-3, A-15 ("the exception from backup withholding for payments to exempt recipients (described in A-21 of § 35a.9999-2) does not apply in the case of payments that are subject to reporting under section 6041, 6041A(a) or 6050A.").

On the other hand, we understand that many U.S. parties to notional principal contracts take the position that no information reporting or backup withholding is required on payments to foreign non-corporate parties because (i) periodic payments on a notional principal contract are not necessarily gains, profits or income,[29]/ (ii) section 6041 does not appear to contemplate notional principal contract income, (iii) it would be anomalous for notional principal contract payments to a foreign non-corporate party to be subject to backup withholding tax while payments of interest to such a party would be exempt,[30]/ and (iv) it would be highly unusual to require 31 percent backup withholding on a payment of foreign source income to a nonresident alien, especially since the United States does not impose substantive federal income tax on such a payment.

3. Information Reporting. If information reporting is required under current law with respect to non-effectively connected notional principal contract payments made to noncorporate payees, such reporting must be done on Form 1096 and 1099.[31]/ Otherwise, Forms 1042 and 1042S are filed with respect to notional principal contract payments that are effectively connected income.[32]/

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[29]/ In Notice 87-4, the Service declined to take a position as to whether swap income qualifies as fixed or determinable annual or periodical income. 1987-1 C.B. 416.

[30]/ Section 6049 generally exempts from information reporting (and, accordingly, backup withholding) interest paid to foreign persons. See Code section 604 9(b)(5).

[31]/ Treas. Regs. § 1.6041-1(a)(2).

[32]/ See Treas. Regs. § 1.1461-2(c) (requirement to file a Form 1042-S showing all items of income specified in section 1441(b) paid during the previous calendar year to foreign persons); Treas. Regs. § 1.1461-2(b)(1); Treas. Regs. § 1.6302-2.

4. Recharacterization of notional principal contracts with a "significant nonperiodic payment". Although the foregoing rules are applicable to notional principal contract income generally, an important exception exists if a notional principal contract provides for a "significant nonperiodic payment" to be made by a foreign person to its U.S. counterparty. Under current law, the notional principal contract generally is bifurcated for U.S. federal income tax purposes into an on-market, level payment notional principal contract and a loan to the U.S. counterparty.[33] The U.S. counterparty is treated as paying interest to its counterparty on the deemed loan over the term of the notional principal contract and these payments are subject to the rules on withholding, backup withholding and reporting for interest payments instead of those for notional principal contract income generally. Accordingly, unless the U.S. party has an appropriate withholding tax certification from its counterparty, the deemed interest payments are subject to 30% U.S. withholding tax (or, in certain circumstances, 31% backup withholding tax).[34]/

B. The Proposed Regulations. The Proposed Regulations would make several changes to these rules.

1. Changes affecting withholding taxes. First, the Proposed Regulations would eliminate the requirement that a U.S. party to a notional principal contract receive a Form 4224 in respect of a payment of effectively connected income.[35]/

33/ Treas. Regs. § 1.446-3(g)(4).

34/ The withholding, backup withholding and information reporting rules for interest are described in Part III.

35/ Prop. Regs. § 1.1441-4(a)(3).

Second, the Proposed Regulations treat a payment made to a foreign partnership as made to its partners.[36]/ Thus, to the extent that a U.S. withholding agent makes a payment on a notional principal contract to a foreign partnership with U.S. partners, no withholding would be required (and no backup withholding would be required to the extent that the withholding agent had received Forms W-9 from the U.S. partners).

2. Changes affecting backup withholding. The Proposed Regulations would expressly subject notional principal contract payments to backup withholding, but would exempt (i) any notional principal contract payment made to a foreign person from which the payor has received a Form W-8, and (ii) any notional principal contract payment made outside the United States (even if the payor does not have a Form W-8), unless the payor has actual knowledge that the payee is a United States person.[37]/

3. Changes affecting information reporting. The Proposed Regulations imply that notional principal contract income is subject to section 6041 information reporting on Forms 1096 and 1099, unless the payor had a Form W-8 from the payee.[38]/ The Proposed treat all notional principal contract

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[36]/ See Prop. Regs. § 1.1441-1 (c)(3)(ii).

[37]/ Prop. Regs. § 31.3406(g)-(1)(e).

[38]/ See Treas. Regs. § 1.6041-1(a)(2) ("The return required by subparagraph (1) of this paragraph shall be made on Forms 1096 and 1099 ...."). This requirement is not affected by the Proposed Regulations. See also Prop. Regs. § 1.6041-4(a)(3)(return of information is not required for non-U.S. source income if the foreign person has furnished a certificate described in section 1.6049-5(c)(1)); Prop. Regs. § 1.6049-5 (c) (1) (referencing § 1.1441-1(e) (1)); Prop. Regs. § 1.1441-1(c) (1) (requiring a Form W-8).

payments made to foreign persons as subject to reporting on Forms 1042 and 1042S (regardless of whether the payment is' effectively connected income.)[39] The Proposed Regulations under section 6041 also state that payments on notional principal contracts are subject to reporting under that section. Although those provisions of the Proposed Regulations specifically cross-reference the Form 1042 and 1042S reporting requirement, indicating that the reporting required for this purpose is Form 1042 and 1042S reporting, they do not explicitly provide an exemption from Form 1099 reporting for such payments, and thus, read literally, the Proposed Regulations could be read as requiring that such payments are subject to reporting under both regimes.

C. Comments and recommendations.

1. General comments. We commend the Service for providing comprehensible rules that deal specifically with the withholding, backup withholding and information reporting requirements relating to notional principal contracts.

2. Comments on withholding tax rules. It would be helpful if the final regulations (under section 1441 or section 446) provide more guidance as to when a notional principal contract contains a significant nonperiodic payment, or provide presumptions upon which a U.S. withholding agent could rely for withholding on a notional principal contract that provides for a nonperiodic payment.

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39/ Prop. Regs. § 1.1461-1(c)(2)(i). The Proposed Regulations would eliminate the rule that permits amounts that are reported on Forms 1042 or 1042S to escape section 6041 reporting. Compare Prop. Regs. § 1.6041-3(a) (omitting Forms 1042 and 1042S) and Treas. Regs. § 1.6041-3(a) (including Forms 1042 and 1042S).

It would also be helpful if the final regulations confirm that a notional principal contract that is documented on an ISDA Master Agreement is a “registered obligation” for purposes of qualifying any interest payments on a deemed loan that arises as a result of Treas. Regs. § 1.446-3(g)(4) for the portfolio interest exemption. Swaps (and their notional principal contracts) documented on standard ISDA Master Agreements are private negotiated contracts between two specific parties. The application of Treas. Regs. § 5f.103-1(c) to swaps is not entirely clear, but the parties to ISDA Master Agreements will always know the identity of their counterparties and deemed loans resulting from swaps documented on such agreements should be regarded as registered form obligations.

3. Comments on backup withholding tax rules. We commend the Service for rationalizing the backup withholding rules with respect to notional principal contracts. We agree that a notional principal contract payment should not be subject to backup withholding if it is made to a foreign person from which the payor has a Form W-8 or if it is made outside the United States. However, we recommend that the final regulations eliminate all backup withholding for foreign source notional principal contract payments (regardless of whether the U.S. withholding agent has received a Form W-8). For purposes of this rule, we would permit a U.S. party to a notional principal contract to determine the residence of its counterparty based on any representation received from the counterparty (i.e., as to foreign status for U.S. federal income tax purposes) or, in the absence of such a representation, based on the presumptions contained in Prop. Regs. § 1.1441-1(f).

It is not current market practice for U.S. parties to notional principal contracts to backup withhold or to request Forms W-8 from their foreign counterparties if the contract does not provide for a significant nonperiodic payment (unless the contract is a section 988 transaction with an offshore investment fund). Moreover, it will often be impossible for U.S. parties to notional principal contracts to independently conclude that their foreign counterparties are treated as corporations for U.S. federal income tax purposes. Accordingly, if the Proposed Regulations are finalized in their current form, unless the payments are made outside the United States, U.S. parties to notional principal contracts will be required to obtain Forms W-8 from their foreign counterparties to avoid backup withholding.

Foreign parties to notional principal contracts are often highly resistant to providing any tax forms to their counterparties. The failure of a foreign counterparty to provide a Form W-8 does not, however, present substantive U.S. federal income tax issues because the income on a notional principal contract is generally foreign source. Moreover, omitting the requirement for a Form W-8 should not present tax avoidance opportunities for U.S. persons. Since notional principal contracts are bilateral private transactions and it is important for credit purposes and other non-tax purposes that a U.S. party "know its counterparty," it is highly unlikely that a U.S. withholding agent could make a payment to a U.S. person and not have actual knowledge of that fact. Moreover, although it is possible that a U.S. party could make a notional principal contract payment to a foreign person that is a partnership for U.S. federal income tax purposes with individual U.S. partners, we believe that the use of such an entity to avoid U.S. federal income tax is minimized by the information reporting requirements of the Proposed Regulations.

If our recommendation is rejected and the backup withholding tax rules for notional principal contracts are retained, we recommend that they not apply to any notional principal contract that was documented before the date the final regulations are published in the Federal Register, in order to avoid disturbing existing transactions that were entered into on the basis that no Form W-8 would be required.

In addition (and regardless of whether our previous recommendations are accepted or rejected) we recommend that a U.S. withholding agent on a notional principal contract be permitted to presume (in the absence of actual contrary knowledge) that its counterparty is a corporation for U.S. federal income tax purposes if the counterparty is organized as an entity listed in Prop. Treas. Regs. § 301.7701-2(b)(8) or if the counterparty provides the U.S. withholding agent with a copy of an election to be treated as a corporation that it represents was filed pursuant to Prop. Treas. Regs. § 301.7701-3(c)[40/]

Finally, we see no reason that the categories of exempt recipients for purposes of section 6041 should be narrower than the comparable list under section 6049. Thus, we would recommend expanding the list of exempt recipients to include all persons exempt under Prop. Regs. § 1.6049-4 (c) (1), including, for example, financial institutions and securities dealers.

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40/ This is discussed further on page 61 below (See XV Information Reporting and Backup withholding -- B. Identification of Exempt Recipients -- 1. Corporations as Exempt Recipients).

4. Comments on information reporting tax rules. We recommend that the final regulations clarify that notional principal contract income is subject to reporting only on Forms 1096 and 1099 (under section 6041) and not on Forms 1042 and 1042S (under section 1441).[41]/ Moreover, for purposes of information reporting we recommend that all payments on a notional principal contract be subject to the regime for reporting notional principal contract payments, even if some of those payments are treated as interest under Treas. Regs. § 1.446-3(g)(4). We believe that these changes would simplify information reporting without impairing the Service's ability to trace payments.

## IX. Withholding in respect of payments to foreign partnerships.

The Proposed Regulations treat payments of U.S. source income made to a foreign entity that is classified as a partnership for U.S. federal income tax purposes as made to the partners of the partnership for withholding tax purposes. The theory is that the partners are the owners of the income for U.S. tax purposes since under U.S. tax principles they are required to include such amounts in income. This rule applies through tiers of partnerships.[42]/

As a consequence, eligibility for an exemption from or reduced rate of withholding will be determined at the partner level. In the case of income subject to an exemption from or

[41]/ This could be achieved most simply by providing in Regs. § 1.6041-1(a)(2) that information reporting for notional principal contracts is made exclusively on Forms 1096 and 1099 and not on Forms 1042 and 1042S and by revising Prop. Regs. § 1.1461-1(c)(2)(i).

[42]/ Prop. Regs. §§ 1.1441-1(c)(3) and 1.1441-5(b).

reduced rate of withholding under a tax treaty, however, the look through rule is subject to a rule which determines the beneficial owner of income under the tax principles of the foreign country and defines "beneficial owner" as the person required to include the amount paid in gross income.[43]/ Thus, in the case of income entitled to treaty relief, the partnership may be treated as the owner of some or all of the payments it receives, depending on the tax principles of the foreign country.[44]/

In the case of interest on registered form debt, the effect of the look through rule is to require the partners, not the partnership, to provide Forms W-8 in order to eliminate U.S. withholding tax unless the partnership becomes a qualified intermediary. In the case of treaty income, the rule will have the same effect, but only to the extent that the relevant foreign country regards the partners as the "beneficial owners" of the income.

The Proposed Regulations provide that the look through rule may be turned off, in the case of treaty income, if the Service determines that the treaty partner does not apply reciprocal treatment to U.S. partnerships or to U.S. partners.[45]/

In evaluating this rule, it may be useful to distinguish between, on the one hand, interest on registered form debt that would be portfolio interest if the appropriate documentation is

[43]/ Prop. Regs. § 1.1441-1 (c) (6) (ii) (B) which state that "the tax principles in effect under the laws of that foreign country shall apply to determine [who is] required to include the amounts in income."

[44]/ Prop. Regs. § 1.1441-1 (c) (6).

[45]/ Prop. Regs. § 1.1441-6(b)(4)(iv).

provided and, on the other hand, dividends, royalties and other items of income that are subject to an exemption from or reduction in withholding tax only under a tax treaty.

By way of illustration, assume that U.S. source interest is paid to a Cayman Islands partnership that has two partners, one a U.K. resident and the other a Swiss resident. If the interest is on registered form debt, and otherwise is "portfolio" interest, each partner would have to provide a Form W-8 on its own behalf and for each of its partners to the U.S. withholding agent in order to eliminate U.S. withholding on the payment to the partnership unless the partnership became a qualified intermediary and certified on behalf of its partners. This would be so without regard to the characterization of the partnership and its income for Cayman Islands, Swiss or U.K. purposes.

Now assume that the partnership also received U.S. source dividends or royalties that would, if received directly by the partners, be eligible for a less than 30% withholding tax under the U.S. treaties with the U.K. and Switzerland. These would likewise be eligible for the reduced rates of withholding provided in the treaties with the U.K. and Switzerland when paid to the partnership, but only to the extent that the U.K. or Switzerland, as the case may be, regarded the dividend or royalty income of the partnership as the income of the resident partner -- if they did not, the dividend or royalty income would to that extent not be eligible for the reduced rate of withholding.

These rules will significantly change the withholding tax treatment of payments to foreign partnerships. Under the present Regulations, payments to a foreign partnership are treated as payments to the partnership.[46] As a consequence, the partnership, not the partners, provides Forms W-8 in respect of interest on registered form debt. If the partnership meets the definition of a resident in an applicable tax treaty jurisdiction, it is the recipient of the dividends or other treaty income for purposes of the treaty. If the foreign partnership does not meet the definition of a resident in a tax treaty jurisdiction, withholding on payment to the partnership would be at a 30% rate, but those partners who were treaty country residents may, depending on the terms of the applicable treaty, be entitled to refunds.

Dividends and other treaty income. In the case of dividends and other treaty income, many of us think the proposed rule is generally sensible from a policy point of view.[47] It extends the benefits of tax treaty reductions or exemptions to partners in a partnership in those cases in which, consistent with the U.S. rules, the treaty country regards the partner as the owner of the income. Determining treaty benefits at the partner level reflects comments that we and others have made in the past.[48]

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[46] See Treas. Regs. § 1.1441-3(f).

[47] Others point out, however, that the rule is not entirely logical -- specifically, if the partner's country of residence viewed the intermediate entity as a partnership, but the U.S. did not, the Proposed Regulations would not apply a look through rule.

[48] See, e.g., Committee on the Taxation of International Transactions, Committee of the Association of the Bar of the City of New York, U.S. Tax Treatment of Partnerships and Partners under U.S. Income Tax Treaties (Tax Notes Today, July 7, 1995); New York State Bar Association Tax Section, Committee on Foreign Activities of United States Taxpayers, Report on Foreign Entity Characterization for Federal Income Tax Purposes, 35 Tax L. Rev. 169 (1980); Loengard, Tax Treaties, Partnerships and Partners: Exploration of a Relationship, 29 Tax Law. 31 (1975).

There is a serious issue, however, as to whether Regulations can deny treaty benefits of a typical U.S. tax treaty to a foreign partner simply because the foreign tax law applicable to the partner does not regard the partner's share of the income of the partnership as includible in the partner's income when it is received by the partnership.

Section 702(b) of the Internal Revenue Code provides that the "character of any item of income ... included in a partner's distributive share" of partnership income "shall be determined as if such item were realized directly from the source from which realized by the partnership". Except where the applicable tax treaty imposes an additional requirement on treaty benefits, it would seem to follow from Section 702(b) that withholding tax exemptions or reductions apply to a foreign partner's distributive share of U.S. source interest, dividends and royalties of a foreign partnership. Some treaties simply extend benefits to income "derived from" sources within the United States.[49]/ While other treaties, like the Proposed Regulations, impose a requirement of "beneficial ownership"[50]/ or "beneficial entitlement[51]/ until the Proposed Regulations those terms had generally been interpreted by the Service and practitioners to require ultimate control (i.e., to be directed at back-to-back and similar arrangements) and not to require

[49]/ E.g., treaty with Belgium (Articles 11 and 12, relating to interest and dividends).

[50]/ E.g., treaties with Canada (Articles X, XI and XII, relating to dividends, interest and royalties), Belgium (Article 10, relating to dividends), France (Articles 10, 11 and 12, relating to dividends, interest and royalties) and Germany (Articles 10, 11 and 12, relating to interest, dividends and royalties).

[51]/ E.g., treaty with Australia (Articles 10, 11 and 12, relating to dividends, interest and royalties);

current inclusion in gross income under foreign tax law.[52] These treaty terms would not seem to mean that a foreign partner is ineligible for treaty benefits unless required under foreign tax law to currently include in gross income the partner's share of partnership income.

As a consequence, while many of us are sympathetic to the concerns that are behind this part of the Proposed Regulations, we conclude that, in the absence of clear authority, this change should be made by revisions to tax treaties -- that is, by including in tax treaties provisions which limit any reduction or exemption from withholding tax for income derived as a partner to cases where the income is included in income by the partner under the tax law of the treaty partner. We recognize that treaty revisions will take a substantial amount of time.

An alternative would be to amend Section 702(b) of the Code. While this might involve overriding tax treaties, it could be done (like the enactment of Section 897) so that existing tax treaties were affected by the amendment only after the passage of a period of years.[53]

We have analyzed the Proposed Regulations' treatment of payments to foreign partnerships as a substantive rule -- that

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[52] The proposed withholding tax regulations issued in 1984, and withdrawn with the issuance of the Proposed Regulations, defined the beneficial owners of income as “the person ... ultimately entitled to control the income”, stating that “[t]hus, for example, a nominee or any person acting in a similar capacity is not the beneficial owner”. Prop. Regs. § 1.1441-6(e)(1)(ii).

[53] It seems to us that treaty partners ought not to object to such an amendment since the current inclusion of the income under the tax laws of the foreign county is generally the predicate for relief from U.S. tax. They may, however, raise the point made in Note 47 above, i.e., that the rule might logically be extended to cases in which the foreign country, but not the U.S., treats the entity as transparent.

is, as a rule that would change the incidence of U.S. tax, not just the obligations of a withholding agent to withhold. If viewed as merely procedural, the Proposed Regulations would be within the scope of the Internal Revenue Service's authority -- that is, withholding could be required at a 30% rate on U.S. source income of foreign partners of a foreign partnership even though the partners were entitled to an exemption from or lower rate of withholding. We think it is unwise, however, to de-couple the obligation to withhold from the substantive tax rule -- for example, to require withholding at a 30% rate on a payment to a foreign partnership when the partners are entitled to a 15% rate.

Assuming that treaties are revised to limit reductions in or exemptions from withholding tax for income derived as a partner to cases where the income is included in income by the partner under the tax law of the treaty partner, or the Internal Revenue Code is so amended, the revisions will have to address the following points:

(1) The extent to which partnership or look-through treatment should be required under foreign law.

The Proposed Regulations are presumably concerned about a case in which a treaty country resident is not currently subject to tax in that country on its share of U.S. source income of an entity classified as a partnership for U.S. tax purposes because the entity is treated as a corporation under foreign law. Assume that this is the case and that as a consequence the foreign country does not regard the foreign partner as receiving its share of the partnership's U.S. source income until it is distributed, but suppose that either (a) the foreign partner is generally exempt from tax (e.g., is a pension plan or a charity), (b) the income is of a type that is not taxable in the foreign country (e.g., dividends under an "exemption" system of taxing foreign income),[54]/ (c) the income is taxed to the foreign partner under foreign law's equivalent of the subpart F rules, or (d) the partnership income is in fact distributed by the partnership on a current basis -- in none of these cases would it seem appropriate to impose a 30% withholding tax if the income would have been subject to a lower rate of withholding, or a withholding tax exemption, had it been paid directly to the foreign partner.

Suppose that the income is received by an entity that is classified as a partnership for U.S. tax purposes and distributed by that entity to its partners in the following year -- is it appropriate in such a case to impose a 30% withholding tax if the income would have been exempt or subject to a reduced rate of tax had it been received directly by the partners? That may seem to be too harsh a penalty for a case in which, at most, there has been a one year deferral of receipt. If the proposed rule is ultimately implemented, however, whether by treaty revisions or amendment to the Internal Revenue Code, it will be necessary to draw an arbitrary line.

(2) How the rule will apply to dividends in the case of a treaty that affords a lower rate (generally, 5%) to dividends received by a corporate shareholder that owns a stated percentage (generally, 10%) of the voting stock of the U.S. corporation.

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[54]/ There may be other differences in the U.S. and foreign tax rules with respect to timing or characterization.

Is there a look-through for that purpose as well? If that is the intent, the point could usefully be clarified. Tax treaties commonly require that 10% of the stock be “owned” by the corporation, and this suggests the need for a change in treaty terms. In the domestic context, however, the Service has under certain circumstances treated stock owned by a partnership as “owned” by its partners for purposes of Section 902[55]/

(3) How the rule will be coordinated with a tax treaty that expressly provides that a partnership will be treated as a resident of the treaty country to the extent that the income is subject to the other country's tax either at the partnership or the partner level[56]/

If, as we have recommended, the look through rule is implemented by tax treaty revisions, those revisions will presumably sort out any arguable inconsistency of between treaties that treat partnerships as residents and any requirement that partners provide documentation in such a case.[57]/

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[55]/ In the domestic context, the Service has ruled that equal corporate partners in a Delaware general partnership owning 40% of the voting stock of a foreign corporation are each entitled to a Section 902 credit in respect of their shares of the dividends received by the partnership. See Rev. Rul. 71-141, 1971-1 C.B. 211.

[56]/ For example, U.S. income tax treaties with the following countries treat partnerships as residents for tax treaty purposes to the extent that the income of the partnership is subject to tax at the partnership or the partner level: Australia, Barbados, China, Cyprus, Czech Republic, Egypt, Finland, France, Germany, Hungary, Iceland, India, Israel, Italy, Jamaica, Malta, Mexico (although Mexican partnerships are typically taxed as entities), Morocco, New Zealand, Poland, Romania, Russia, Slovak Republic, South Korea, Spain, Sri Lanka, Sweden, Tunisia and the U.K.

[57]/ As a substantive matter, treating partnerships as treaty country residents to the extent of the interest in the partnership of residents of the country should not affect the amount of withholding tax, since treatment as a resident is limited to cases in which the income of the partnership is taxed as income of a resident.

Under the Proposed Regulations, the Internal Revenue Service may turn off the look through rule for treaty income if the foreign country does not reciprocate. If, as recommended, the look through rule is implemented only by treaty, the reciprocity requirement would presumably also be in the treaty. We note, however, that the rule in the Proposed Regulations applies where the lack of reciprocity is with respect to either the treatment of a U.S. partnership or the treatment of U.S. partners. It is unclear to us what legitimate interest the U.S. has in protecting foreign partners of U.S. partnerships, and we suggest therefore that the authority extend only to a case where there is no reciprocity with respect to U.S. persons who hold interests in an entity and are treated as the beneficial owners of the entity's income under the law of the foreign country and are denied treaty relief in respect of the income.

Interest on registered form debt. The consequence of treating partners of a foreign partnership that receives interest on registered form debt as the recipients of the income is to require the partners to provide Forms W-8.

We question whether there is any persuasive policy reason to require Forms W-8 from partners rather than from the partnership in the case of interest on registered form debt. As set forth above (see III. Withholding in respect of interest on registered form portfolio debt), there is no strong case for requiring beneficial ownership information from beneficial owners in a case where the obligations are held by an intermediary, and extending that requirement even further than under present law, by requiring partners to provide such information, seems to us to be unnecessary. We also have reservations as to the statutory authority for requiring partners to provide Forms W-8.[58]/

If partners in a foreign partnership are nonetheless treated for withholding tax purposes as the owners of interest received by the partnership on registered form debt that would otherwise be "portfolio" indebtedness, the proposed regulations might usefully clarify whether the look-through treatment of foreign partnerships has any effect on whether interest paid to a foreign partnership that owns 10% or more of the issuer's stock will be excluded from the definition of portfolio interest by Section 871(h)(3)(B) if no partner owns that percentage of the issuer's stock.[59]/ It might be inferred from the look through rule that Section 871(h)(3)(B) is to be applied at the partner level.

X. Payments to domestic partnerships. The Proposed Regulations do not make substantive changes in the rules that now apply to domestic partnerships.[60]/ As a consequence, there is no withholding on payments to a domestic partnership but the partnership is responsible for withholding in respect of distributions to, or amounts credited to the capital accounts of,

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[58]/ Section 871(h) (2) (B) (ii) requires such a statement from the "beneficial owner" of the obligation, but in the more than 12 years since the repeal of the withholding tax on "portfolio interest" it has never been suggested that an "aggregate" approach to partnerships should be used for purposes of Form W-8.

[59]/ See NYSBA, Report on the 'Bank Loan' Exception to the 'Portfolio' Interest Rules, dated August 28, 1992 (see part VI, Partnerships), reprinted in Tax Notes, September 17, 1992, 92 TNT 189-37; Staffaroni, Partnerships: Aggregate vs. Entity and U.S. International Taxation, 49 Tax Lawyer 55, 122-23 (1995); Gordanier, Structuring Securities Partnerships for Tax-Exempt and Foreign Investors, Journal of Partnership Taxation, Summer 1990, 135, 139-40.

[60]/ Prop. Regs. § 1.1441-5 (a). The present rules are set out in Regs. § 1.1441-3(f) and Rev. Rul. 89-33, 1989-1 C.B. 269.

foreign partners. Consistent with Rev. Rul. 89-33, 1989-1 C.B. 269, the Proposed Regulations expand on the guidance provided by the present regulations to specify the time at which a partnership must withhold in respect of undistributed income.

Although there is no look-through in the case of a domestic partnership, the results of treating such a partnership as an entity are, in the case of dividends and other treaty income, generally consistent with the proposed treatment of foreign partners of foreign partnerships -- that is, eligibility for treaty benefits is determined at the partner level.

For the reasons set forth above (see IX. Withholding in respect of payments to foreign partnerships), this seems to us to be consistent with Section 702(b) of the Code and tax treaty obligations, and we think it should therefore apply without regard to whether the foreign country does or does not apply a look through to the domestic partnership.

The different treatment of foreign and domestic partnerships does, however, attach considerable significance to what may be nothing more than the choice of governing law, since a partnership will be domestic, or not, depending on whether it was created or organized in the United States or under the law of the United States or of a State.[61]/ Because the difference is so minor, it is in fact difficult to see why a foreign partnership would ever bother to become a qualified intermediary, given the ease with which it could hold U.S. securities in a domestic partnership and achieve, at less inconvenience, the same effect for withholding tax purposes.

[61]/ Section 7701(a)(4) of the Code.

Suppose a domestic partnership has U.S. source interest and dividend income, and that the interest is, as to a foreign partner, free of withholding tax and the dividends are, as to that partner, subject to a 15% withholding tax. On what should the partnership withhold if the partnership makes a distribution of less than all of the amount credited to the partner's account? Like the present regulations, the Proposed Regulations do not answer this question but simply state that a domestic "partnership shall withhold when any distributions that include items of income subject to withholding are made".[62]/ As discussed below (see paragraph (1)(b) of XII. Payments to and by fiduciaries), in the case of payments by trusts and estates, the Code treats distributions of income consist of pro-rata portions of each class of items included in the distribution. This convention could be usefully adopted in this situation.

XI. Possible revisions to the rules relating to domestic partnerships

We understand that consideration is being given to extending the proposed rules for treaty income of foreign partnerships to treaty income of domestic partnerships.[63]/ As we understand this, there would (as under the present Regulations) be no U.S. withholding on payments to a domestic partnership, but a domestic partnership would withhold at a 30% rate on any treaty income of a foreign partner that was a treaty country resident unless the foreign treaty country regarded the partner as the beneficial owner of the income (i.e., as required to include such

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[62]/ Prop. Regs. § 1.1441-5(a)(2)(i).

[63]/ Remarks attributed to Philip R. West, Deputy International Tax Counsel, in BNA, Daily Tax Report, No. 143, July 25, 1996.

amounts in income when received by the partnership). The theory of this rule is that the extension of tax treaty benefits to a foreign partner in a U.S. partnership is premised on the treatment of that partner as the recipient of the income under the foreign country's tax laws.[64]/ It is apparently a response to the fact that, under the laws of some treaty countries, limited liability companies, although classified as partnerships for U.S. tax purposes, are not so classified for purposes of the treaty country's tax laws.[65]/

As set out above (see IX. Withholding on payments to foreign partnerships), it seems to us to be inconsistent with Section 702(b) of the Internal Revenue Code to deny treaty benefits to foreign partners simply because the treaty country's tax law does not regard the partner's share of the income of the partnership as includible in the partner's income when it is received by the partnership. Tax treaties do not expressly condition treaty benefits on current taxation of the income under the laws of the foreign country. The change would also raise all of the technical issues, discussed above, as to the circumstances under which it made sense to impose a 30% withholding tax on U.S. source income simply because a foreign partner was not required to include in income the partner's share of that income currently. Finally, such a rule could require that withholding agents determine the treatment of various items of income under the foreign law relevant to each partner, which we believe is an inappropriate burden to impose on withholding agents.

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[64]/ See West, Foreign Law in U.S. International Taxation: The Search for Standards, 3 Florida Tax Review 147, 179-182 (1996).

[65]/ Id.

The possibility that the rules with respect to domestic partnerships will be changed is nowhere mentioned in the preamble or text of the Proposed Regulations, would be a marked departure from the present rules and what is in the Proposed Regulations and raises complicated policy and technical issues. If, contrary to our recommendation, the Service decided to make such a change by regulations, we assume that under the circumstances those regulations would be issued in proposed form, with an opportunity for public comment.

## XII. Payments to and by fiduciaries.

Current law provides that there is no withholding in respect of payments to a domestic fiduciary of a trust or estate, other than a domestic fiduciary for a grantor trust of a foreign grantor, but such domestic fiduciaries must withhold in respect of amounts of U.S. source income which are distributed or are required to be distributed currently to a foreign beneficiary.[66]/ Subject to applicable exemptions, payments of U.S. source income to a foreign fiduciary are subject to U.S. withholding,[67]/ as are payments to a U.S. grantor trust if the grantor is foreign.[68]/ The income of the trust or estate generally retains its character for the purposes of applying the withholding tax rules to the beneficiary.[69]/

[66]/ Treas. Regs. §§ 1.1441-2(a)(2) and 1.1441-3(f) and (g).

[67]/ Treas. Regs. § 1.1441-3(f).

[68]/ Treas. Regs. § 1.1441-3(g).

[69]/ Sections 652(b), 662 (b). *See*, *e*.*g*., Rev. Rul. 86-76, 1986-1 C.B. 284; Rev. Rul. 81-244, 1981-2 C.B. 151; Rev. Rul. 68-605, 1968-2 C.B. 390; Rev. Rul. 55-514, 1955-1 C.B. 385.

The Proposed Regulations leave in place the rules currently applicable to payments of U.S. source income to and by fiduciaries, as outlined above.[70]/ We think the Proposed Regulations should be revised in order to address several issues not addressed by the current regulations and in order to better relate the current regulations to the Proposed Regulations.

(1) Domestic Trusts and Estates.

(a) As briefly summarized above, and consistent with Sections 652(b) and 662(b), the Service has concluded in several revenue rulings that income distributed by a trust or estate has the same character to a foreign beneficiary as when paid to the domestic fiduciary.[71]/ None of these rulings, however, has applied this principle in the context of a tax treaty. Consequently, it would be helpful to have an express statement that the rate of withholding on U.S. source income (i.e., dividends, interest or royalties) paid to a domestic fiduciary and distributed to a foreign beneficiary is the rate that would apply had such income been received directly by the beneficiary.

(b) In the absence of the specific allocation of different classes of income under the terms of the governing instrument of a trust or estate, Sections 652(b), 661(b) and 662(b) of the Code treat distributions of distributable net income as consisting of a pro-rata portion of each class of items

[70]/ Prop. Regs. § 1.1441-1(c)(6)(ii)(C).

[71]/ See also Treas. Regs. § 1.1441-2 (a) (2) (statement that the “share of the fixed or determinable annual or periodical income of an estate or trust from sources within the United States which is required to be distributed currently . . . to a nonresident alien beneficiary of such estate or trust constitutes fixed or determinable annual or periodical income”).

entering into its determination. This convention could be usefully adopted to determine the amount to be withheld by a domestic fiduciary in a case where less than all of the income of the trust or estate is subject to U.S. withholding tax at a 30% rate. We thus propose that, absent specific allocations to the contrary in the governing trust or estate instrument, that distributions be deemed to consist of a pro-rata portion of each of the items of income received by the trust or estate.

(c) Current regulations provide that "the share of the fixed or determinable annual or periodical income of an estate or trust from sources within the United States which is required to be distributed currently, or which has been paid or credited during the taxable year, to a foreign beneficiary of such estate or trust constitutes fixed or determinable annual or periodical income" subject to withholding.[72]/ The regulations, however, do not provide guidance as to when such income is subject to withholding. In contrast, the Proposed Regulations generally provide with respect to domestic partnerships that such partnerships shall withhold with respect to items of income that are subject to withholding either (i) when distributions that include such items of income subject to withholding are made, or (ii) if such items are not currently distributed, on the earlier of the date that the Section 6031 (b) statement is mailed or otherwise furnished to the partner or the due date for furnishing such statement.[73]/ We believe that the Proposed Regulations should adopt a similar convention with respect to the income of a trust or estate that is required to be distributed currently but has not been distributed by year end. Thus, the income of a

[72]/ Treas. Regs. § 1.1441-2(a)(2).

[73]/ Prop. Reg. § 1.1441-5(a)(2).

trust or estate that is subject to withholding would be subject to withholding at either (i) the time such income is actually distributed to its foreign beneficiary, or (ii) if such income was required to be distributed currently, at the earlier of the time that the Section 6034A statement is mailed or otherwise furnished to the beneficiary or the due date for furnishing such statement.

(d) The Service has set out in several revenue rulings its position with respect to the treatment of amounts distributed by a trust or estate that exceed distributable net income and the availability of the Section 667(b) credit for taxes paid by a trust as applicable in determining a beneficiary's tax liability related to accumulation distributions.[74]/ Without endorsing the correctness of those rulings as statements of present law, we believe that consideration should be given to incorporating any rules with respect to such distributions in the Regulations.

(e) As described above, the Proposed Regulations would continue the rule set forth in the current regulations that requires withholding on payments to a domestic fiduciary for a grantor trust in a case where the grantor is a foreign person.[75]/ We think that this rule is administratively difficult to implement and that it would be preferable to treat payments to all domestic fiduciaries similarly.

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[74]/ See Rev. Rul. 59-177, 1959-1 C.B. 229, and Rev. Rul. 68-605, 1968-2 C.B. 390.

[75]/ Prop. Reg. § 1.1441-1(C) (6) (ii)(C).

Whether or not a trust is a grantor trust and, if so, to what extent, may be a complicated question and it is unlikely that in most cases a U.S. withholding agent has any basis on which to make these determinations, much less know whether or not the grantor is a foreign person. Further, it is probable that there will always be some foreign "grantors" (i.e., beneficiaries) in the case of publicly traded grantor trusts (for example, those holding debt instruments or other similar assets) but completely unclear how the payor will know the extent of the foreign ownership and thus its withholding obligations. We believe that adopting a rule treating payments to all domestic fiduciaries similarly would entail no risk of underwithholding because the fiduciary would be required to withhold in respect of the foreign grantor's share of the trust's income.

(2) Foreign Trusts and Estates.

(a) The Proposed Regulations continue the rule established in the current Regulations that payments to a foreign fiduciary of a trust or estate are subject to with-holding, regardless of whether the beneficiaries are foreign or U.S. persons.[76]/ In contrast, the Proposed Regulations with respect to payments to foreign partnerships adopt a look-through approach and treat such payments as a payment to each of such partnership's partners.[77]/

We have recommended that any such look through rule be adopted by revisions to tax treaties or amendment to the Internal Revenue Code. If there are such revisions, however, we

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[76]/ As in the case of partnerships, some treaties may treat a foreign trust or estate as a treaty country resident.

[77]/ see Prop. Reg. 1.1441-5(b).

believe that it would be appropriate to adopt a similar rule for payments to foreign fiduciaries. Such a rule would apply to payments to foreign trusts or estates if the income is, or is required to be currently, distributed to a treaty country resident and treated as owned by a treaty country resident under the terms of the treaty or the laws of the treaty country. In these cases, the requirement of automatic withholding would produce the wrong result. Further, looking through a trust or estate to the ultimate beneficiaries in determining withholding obligations better conforms the treatment of payments to a foreign fiduciary with those applicable to payments to a domestic fiduciary who may apply treaty exemptions and reductions in rate in determining the withholding obligation with respect to distributions to foreign beneficiaries.

(b) Finally, the Proposed Regulations propose a procedure by which certain foreign persons may become “qualified intermediaries” and furnish a single intermediary withholding statement certifying on behalf of beneficial owners, intermediaries (such as agents or nominees acting for the accounts of others), other qualified intermediaries or U.S. payees for the purpose of claiming reduced rates of withholding tax under Sections 1441, 1442 or 1443. Qualified intermediaries must generally obtain certification or documentation from those persons on whose behalf the intermediary withholding certificate is provided and are able to either assume primary responsibility for withholding and reporting to the Service (if permitted) or to leave that responsibility to the withholding agent.[78]/ The

[78]/ See Prop. Reg. § 1.1441-1(e)(5).

definition of qualified intermediary is limited to certain financial institutions or clearing organizations, partnerships and “other persons acceptable to the Service.[79]/

We believe that the qualified intermediary procedure may usefully be applied to foreign trusts with many beneficiaries if, as we have recommended. We therefore propose that the definition of qualified intermediaries be expanded to include foreign fiduciaries of foreign trusts. In this manner, the treatment of such foreign trusts will be harmonized with that of similarly situated, albeit differently organized, foreign partnerships. We believe that the adoption of such an expanded definition does not present a risk of underwithholding different from that of foreign partnerships and that the provisions of such a qualified intermediary's withholding agreement with the Service can be crafted to address any other concerns of the Service.

## XIII. Consolidation of Exemption Certificates.

We applaud the Service's proposal to provide a single, coordinated set of procedures for all withholding certificates. Under current law, the procedures to be followed to provide, and renew, exemption certificates vary significantly depending on the nature of the exemption claimed. For example, a Form 4224 is valid for only one year and must be provided to the withholding agent, in duplicate, prior to the payment for which the withholding tax exemption is claimed,[80]/ while only a single Form 1001 must be provided and such form is valid for three years and

[79]/ Prop. Reg. § 1.1441-1(e)(5)(ii).

[80]/ Treas. Regs. § 1.1441-4(a)(2).

can be provided after the relevant payment is made[81]/ (although in practice withholding agents typically collect withholding tax if they do not have such forms on file on the date the payment is made). Withholding agents are required to forward copies of Form W-8, but not Form 1001 or 4224, to the Service.[82]/ By providing a single set of procedures to be followed with respect to exemption certificates relating to portfolio interest, treaty relief for portfolio investments, effectively connected income and withholding tax relief for foreign governments, the Proposed Regulations would significantly reduce confusion among withholding agents and non-U.S. beneficial owners. In addition, under the Proposed Regulations, Form W-8, which is valid for three full years in all cases, and is valid indefinitely in some cases if a TIN is provided, would have a longer period of validity than any of the forms it replaces, further reducing withholding agents' and beneficial owners' paperwork burdens.[83]/

Notwithstanding the benefits of the Proposed Regulations unification of these procedures, we question whether combining all withholding certificates' into a single form is the most effective way to accomplish this simplification. The Service

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[81]/ Treas. Regs. § 1.1441-6(c) (2); Casanova Co. v. Commissioner, 87 T.C. 214 (1986), acq. 1990-2 C.B. 1.

[82]/ See Treas. Regs. §§ 1.1441-6(c)(2); 35a.9999-5, Q&A 9; Instructions to Form 4224.

[83]/ Forms 4224 and 8709 currently are valid for only one year. Although Form W-8 is valid for three years, because withholding agents typically attempt to have forms renewed prior to their expiration and the first year of a Form W-8's validity is the year in which it is received, the first year of validity for a renewed Form W-8 typically will coincide with the third year of validity for the predecessor Form W-8 and thus, as a practical matter, Form W-8 generally must be renewed every two years. Finally, although Form 1001 is valid for a full three years, that period is shorter than the validity period for new Form W-8, which is valid for the remainder of the year, in which it is provided plus three additional years.

has not yet released a draft of the new Form W-8, but it appears that the form by necessity will be quite complicated. Depending on the type of withholding tax relief sought, the Proposed Regulations provide an extensive list of information and certifications that may be required to be included in Form W-8. For example, a Form W-8 claiming treaty relief in respect of dividends on non-publicly-traded stock paid to a qualified intermediary may be required to include all of the following:

(i) a statement that the person providing the form is an intermediary;

(ii) the name, address, TIN and signature of the intermediary;

(iii) a certification that the intermediary is a qualified intermediary;

(iv) a certification that the intermediary has obtained beneficial owner documentation;

(v) a statement relating to whether the intermediary is assuming primary withholding responsibility;

(vi) if the intermediary is not assuming primary withholding responsibility, (A) a separate identification of all assets attributable to U.S. beneficial owners, together with a Form W-9 for, or the name and address of, each such owner and (B) a separate identification of assets attributable to non-U.S. beneficial owners, broken down into categories based on the relevant withholding tax rate;

(vii) statements regarding compliance with the TIN certification, advance ruling and treaty-based return position disclosure requirements for treaty relief; and

(viii) any other information that the Form W-8 or its instructions may require.[84]/

Exemption claims in respect of effectively connected income, income received through intermediaries that are not qualified intermediaries and income received through partnerships may

[84]/ See Prop. Regs. §§ 1.1441-1(e)(3)(i), -1(e)(3)(ii), -1(e)(4)(vii), -1(e)(5)(iv)(B) and -6(b).

require the provision of completely different, although equally extensive, information. In addition, the Proposed Regulations permit beneficial owners to provide a single Form W-8 in respect of all of their U.S.-source income.[85]/ As a result, a single Form W-8 may include extensive information relating to several different types of income.

Because certain withholding tax exemptions require the provision of extensive information and because a single Form W-8 may provide such information with respect to several different types of income, Form W-8 is likely to be a very long and complex document. It may be possible for the Service to draft a relatively simple form that provides a blank space for any required information to be provided; however, given the amount of information that may be required, such an abbreviated form would be very difficult for beneficial owners to use properly unless the form includes very detailed instructions. In either case, the form is likely to be difficult for beneficial owners to complete properly. Moreover, withholding agents are likely to find it difficult to determine whether the form has been completed properly and to process such a complex form efficiently.

The combination of all of the exemption certificates into a single document will create other complications for withholding agents and beneficial owners. For example, withholding agents no longer will be able to determine the basis for an exemption simply by reference to the number of the relevant form, but instead will be required to perform a more painstaking analysis of the contents of the form. In addition,

[85]/ Prop. Regs. § 1.1441-1(e)(2)(i).

it may be more difficult for a withholding agent to determine when a new Form W-8 expires. Any Form W-8 that claims an exemption in respect of both effectively connected income and any other type of income will expire in part after three years, complicating withholding agents' ability to develop systems that will permit them to determine whether, and to what extent, Forms W-8 that they have on file continue to be valid.[86]/

Virtually all of the relief provided by the Proposed Regulations' form simplification effort could be accomplished by adopting a uniform set of procedures for all forms without adopting a single form that applies for all purposes. Accordingly, we would encourage the Service to consider limiting its simplification efforts to this procedural unification. If the Service decides to maintain a single form of withholding certificate, we assume that it will be released as a draft so that withholding agents and beneficial owners have an opportunity to comment.[87]/ In addition, a provision of the Proposed

[86]/ The form will expire after three years with respect to the effectively connected income pursuant to Prop. Regs. § 1.1441-1(e)(4)(ii)(C). However, because the beneficial owner will have provided a TIN in respect of its effectively connected income, the form will continue to be valid indefinitely for the other income.

Presumably, withholding agents will deal with this problem simply by requiring that the Form W-8 be renewed in full every three years, effectively eliminating in these cases a beneficial owner's ability to provide a Form W-8 in respect of portfolio income that is valid indefinitely.

[87]/ We also would encourage the Service to consider naming the new form something other than “Form W-8.” Under the Proposed Regulations' transition rules, withholding agents will continue to hold old Forms W-8 through the end of 1999, but will begin relying on new Forms W-8 beginning in 1998. The Proposed Regulations thus create a situation where, throughout a two-year period, withholding agents will hold two different types of forms that have the same name and yet have significantly different legal consequences, greatly complicating withholding agents' ability to develop systems that will appropriately identify the scope of the withholding tax exemptions that beneficial owners have established and the validity period of forms that they hold.

Regulations that is intended to simplify further beneficial owners' ability to qualify for withholding tax exemptions may exacerbate the concerns raised above. As noted above, the Proposed Regulations specifically provide that a beneficial owner is permitted to provide a single Form W-8 to claim all withholding tax exemptions to which the beneficial owner is entitled in respect of all of its U.S. source income. However, this rule may significantly complicate a withholding agent's ability to comply with the Proposed Regulations. Withholding agents often establish multiple accounts for a customer to segregate different types of income (i.e., income entitled to different exemptions) to enable them to determine easily the exemption available with respect to a particular payment. Thus, a withholding agent might require a customer to establish separate accounts for effectively connected income and income for which treaty relief is sought and to provide a Form 4224 for the first account and a Form 1001 for the other.[88]/ Withholding agents' ability to develop systems to permit them to satisfy the requirements of the Proposed Regulations will be significantly complicated if they are required to accept a single withholding certificate in respect of income that is held in several accounts. Thus, if the single form approach is retained, we recommend that the Service consider permitting a withholding agent to request a separate Form W-8 for each separate type of

[88]/ A beneficial owner may even claim different exemptions in respect of the same type of income -- for example, it may receive some interest income that constitutes effectively connected income and other interest income that is not effectively connected and for which it claims the benefits of the portfolio interest exemption or tax treaty relief. In such a case, it may be extremely difficult for a withholding agent to associate the relevant exemption with a particular payment without some form of separate account system.

exemption claimed, or for each account held by a customer.[89]

XIV. Amounts subject to withholding.

Interest. Under Prop. Regs. § 1.1441-3(b), withholding on interest payments is determined by reference to the gross amount of “stated interest”, regardless of whether such stated interest is interest income or a return of capital (i.e., principal) subject to the reimbursement or set-off procedures for overwithheld amounts described in Prop. Regs. § 1.1461-2(a) and the mechanism under Treas. Regs. § 301.6402-2 by which beneficial owners may receive refunds or credits[90]

We question, however, whether this rule is appropriate or authorized by Sections 1441 and 1442. We have a number of comments, as follows:

(1) In the case of a debt instrument that has stated interest payments that are not interest (as would occur, for example, if the debt instrument paid interest in excess of the yield on the instrument in its early years), the mere fact that such payments are denominated as interest should not provide the Service with the authority to impose withholding since for all relevant federal income tax purposes such payments would not be treated as interest. Conversely, if the stated interest paid in

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89/ Such a rule would be analogous to current Treas. Regs. § 1.6049-5 (b) (2) (iv), which permits a payor to request a separate Form W-8 for each interest payment made. This rule also applies for portfolio interest purposes pursuant to Treas. Regs. § 35a.9999-5, Q&A 9.

90/ It is not clear why Prop. Regs. § 1.1441-3 (b) states that the beneficial owner’s claim for refund or credit may be made under Treas. Regs. § 301.6402-2, not Treas. Regs. § 1.1464-1 as provided in Prop. Regs. § 1.1441-3(c)(4) with respect to a beneficial owner’s claim of refund or credit in connection with taxes withheld on the payment of a distribution.

later years is less than the yield, withholding in the later years should be based on interest income for Federal income tax purposes, not stated interest.

The anomaly of tying withholding to stated interest becomes more acute in light of the fact that the Proposed Regulations would revise the current regulations to provide that certain corporate distributions may be treated as returns of capital for purposes of the withholding rules if the distributing corporation can reasonably estimate that its earnings and profits will not be sufficient to cover the distributions.[91]/ Given that the calculation of amounts that are treated as interest is more predictable than the determination as to whether a corporate distribution will be a dividend or a return of capital, withholding should not be required in respect of payments that are not treated as interest, notwithstanding that such amounts may be characterized as interest under the governing instrument. To implement a system of withholding only on amounts that do not represent returns of principal, the Proposed Regulations should provide rules under which either the issuer or the beneficial owner of the interest would provide information to the withholding agent as to the proportion of interest and return of principal included in the total amount of stated interest payable.

Prop. Regs. § 1.1441-3 (b) has the potential to impose disproportionate penalties on a withholding agent. Prop. Regs. § 1.1461-l(a)(2) provides that penalties under sections 6656, 6672 and 7202 and the regulations thereunder may apply to a withholding agent for failure to timely pay tax required to be

[91]/ Prop. Regs. § 1.1441-3(c)(2).

withheld. Where a debt instrument provides for stated interest that is in part for tax purposes a return of principal, a withholding agent who fails to withhold will be liable for a penalty equal to the tax not withheld, even though the beneficial owner would have been entitled to a refund of tax withheld on amounts that were returns of principal. The Proposed Regulations should be changed to avoid that consequence -- the amount of penalty which can be imposed should be commensurate with the liability of the taxpayer on whose behalf withholding occurs.[92]/

(2) As noted in Part VI above, Prop. Regs. § 1.1441-2(b)(3) provides for withholding in respect of original issue discount in specified cases. Consequently, there is a potential for that rule to conflict with Prop. Regs. § 1.1441-3 (b) if the debt instrument is issued at an original issue discount and has stated interest which is not “qualified stated interest” under Treas. Regs. § 1.1273-1 (c). For example, when a payment of stated interest is due on a debt instrument, if the debt instrument had recently been purchased from a related seller and had given rise at that time to withholding on original issue discount under Prop. Reg. § 1.1441-2 (b) (3) (iii), any withholding now required on the stated interest would be doubling up on amounts that had been withheld with respect to such interest at the time of the purchase.[93]/ (The potential conflict is somewhat alluded to in Prop. Regs. § 1.1441-3(a), which states that “[e]xcept as otherwise provided in regulations under section

[92]/ This is not to say that penalties cannot be imposed on a withholding agent in a case where the owner of the income subsequently pays the tax. See Section 1463 of the Code.

[93]/ While Prop. Regs. § 1.1441-3(b) (2) (i) provides that no withholding is required upon interest accrued on the date of a sale of a debt obligation when the sale occurs between two interest payment dates, withholding that was required at the time of a sale under Prop. Regs. § 1.1441-2 (b)(3) could give rise to a duplication of withholding.

1441, the amount subject to withholding under § 1.1441-1 is the gross amount of income subject to withholding.") We believe that it would be helpful if there were a rule to coordinate the operation of Prop. Regs. §§ 1.1441-3(b) and 1.1441-2(b)(3). Such a rule might indicate that Prop. Regs. § 1.1441-3(b) would be modified in the context of original issue discount to take into account any amounts withheld under Prop. Regs. § 1.1441-2(b)(3).

(3) While Prop. Regs. § 1.1441-3(b) provides that a beneficial owner may claim a refund or credit, it should indicate that, alternatively, the withholding agent is entitled to claim a refund or credit under Regs. § 1.6414-1 (as Prop. Regs. § 1.1441-3(c)(4) provides with respect to overwithholding on distributions).

Dividends. The Proposed Regulations would revise the rules relating to corporate distributions to eliminate any obligation to withhold on distributions not out of earnings and profits.[94]/ This makes sense and conforms the withholding tax rules to Section 1441 and 1442, which only require withholding in respect of amounts that constitute "income".

The new rule is optional with the corporation, which may either withhold on the entire distribution or base its withholding on a reasonable estimate of its earnings and profits.[95]/ The rule would be clearer if it were expressly stated that withholding was required on the amount of the distribution or, at the corporation's election, on the basis of a reasonable estimate of earnings and profits.

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[94]/ Prop. Regs. § 1.1441-3(c).

[95]/ Prop. Regs. § 1.1441-3 (c) (2).

The Proposed Regulations also set out a more comprehensive list of other corporate distributions that are not subject to withholding than is set out in the present Regulations.[96]/ Assuming that this list is intended to be comprehensive, we suggest that it be expanded to include capital gain dividends of real estate investment companies that are not subject to withholding under Section 1445 (i.e., distributions of capital gain attributable to the sale of mortgages and other assets that are not interests in United States real property for purposes of section 897). There is no reason why such dividends should not be given the treatment afforded by the Proposed Regulations to capital gains dividends of regulated investment companies.

The Proposed Regulations provide that, if a regulated investment company (and, under our suggestion, a real estate investment trust) underwithholds and subsequently corrects that underwithholding by overwithholding, as contemplated by Prop. Regs. § 1.1461-2(b), the adjustment is not a distribution for purposes of section 562 (c).[97]/ It seems to us that it has no effect on the income of the foreign shareholder at all and that it would therefore be more accurate to say that the adjustment is not a distribution for any purpose and also to provide that an adjustment for overwithholding is not a distribution for any purpose.

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[96]/ Prop. Regs. § 1.1441-3(c)(1).

[97]/ See Prop. Regs. § 1.1441-3(c)(3).

## XV. Information Reporting and Backup withholding.

### A. Extension of Reporting Obligation to Non-U.S. Payors.

The Proposed Regulations except from information reporting on Form 1099 payments of foreign source dividends and other distributions, if such payments are made outside the United States by a non-U.S. payor or a non-U.S. middleman.[98]/ Similarly, exceptions from reporting are provided under the same circumstances for payments of foreign source interest (including original issue discount)[99]/ and miscellaneous income.[100]/ However, U.S. source payments of dividends or distributions, interest (including original issue discount) on many common types of debt obligations[101]/ and miscellaneous income are apparently required to be reported on Form 1099 even though such payments are made outside the United States by a non-U.S. payor or a non-U.S. middleman. This reporting obligation is excused only if the beneficial owner of the income is documented as a foreign person[102]/ or an exempt recipient. Thus, a non-U.S. payor or middleman that makes payments of U.S. source income would be

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98/ Prop. Reg. § 1.6042-3(b)(1)(iv).

99/ Prop. Reg. § 1.6049-5(b)(6).

100/ Prop. Reg. § 1.6041-4 (b)(2).

101/ Interest on the following types of debt obligations are explicitly excepted from information reporting when paid outside the United States by a non-U.S. payor or middle-man: (1) portfolio interest on bearer obligations or on foreign targeted registered obligations (Prop. Reg. § 1.6049-5(b)(7)); (2) interest on certain foreign-targeted short-term debt obligations (Prop. Reg. § 1.6049-5(b)(10); and (3) interest on certain foreign-targeted bank deposits (Prop. Reg. § 1.6049-5(b)(11).

102/ Prop. Reg. §§ 1.6041-4(a)(1), 1.6042-3 (b)(1)(v) and 1.6049-5(b)(7), (12) and (14).

required to develop and implement the documentation procedures necessary to establish the status of its payees as foreign persons or exempt recipients or to prepare and file information returns on Form 1099 for payments made to non-exempt recipients.

In the first instance, we think that non-U.S. payors and middlemen will be caught unaware of this new reporting obligation, because it is derived from a negative inference in the Proposed Regulations and that once understood, this reporting obligation will be viewed as an inappropriate assertion of U.S. authority abroad.[103]/ Further, there is serious doubt as to whether the Service has jurisdiction over foreign payors and middlemen that have no assets or presence in the United States. The inability of the Internal Revenue Service to enforce the proposed rule will make its application haphazard and inconsistent at best, and we do not think the Internal Revenue Service should adopt rules if it cannot realistically enforce them. Finally, the reporting obligation may be in violation of local bank secrecy or other applicable laws. In any event, such matters are better left for negotiation with foreign governments in connection with tax treaties and information exchange agreements than for unilateral regulation.

Accordingly, we recommend that the Proposed Regulations be amended so that no reporting obligation is imposed on non-U.S. payors or middlemen. This can be accomplished by limiting the substantive reporting obligations under sections 6041, 6042 and 6049 to apply only to U.S. payors or middlemen, as defined in the Proposed Regulations.[104]/ As an example, we note that for

[103]/ Our comments here are not directed at persons who are qualified intermediaries.

[104]/ Prop. Reg. §§ 1.6042-3(b)(2)(i) and 1.6049-5(d)(i).

purposes of information reporting on gross proceeds and barter exchanges, the term "broker" is limited to persons described as a U.S. payor or a U.S. middleman.[105]/

B. Identification of Exempt Recipients.

1. Corporations as Exempt Recipients. As indicated in the Preamble, the Proposed Regulations prospectively repeal the "eyeball" test for corporations in the case of payments of interest, dividends and gross proceeds made to new accounts.[106]/ Under current rules, a payor may identify a payee as a corporation exempt from information reporting on Form 1099, without requiring documentation, if the name indicates unambiguously that the payee is a corporation, whether domestic or foreign, by any of the following words or standard abbreviations: Incorporated or Inc.; Corporation, Corp. or P.C. (but not Company or Co.); insurance company; indemnity company; reinsurance company or assurance company. In the absence of the eyeball test, the payee will have to provide either a corporate resolution, a Form W-9 with a statement that it is a domestic corporation or a Form W-8 with a statement that it is a foreign corporation. In addition, an employer identification number ("EIN") must be included on the Form W-9 or on certain Forms W-8.

The Preamble indicates that the proposed documentation requirement is premised upon an understanding that financial institutions routinely request a corporate resolution when opening new accounts for legal entities. Therefore, it would improve compliance without a significant increase in

[105]/ Prop. Reg. § 1.6045-1(a)(1).

[106]/ Prop. Reg. § 1.6049-4(c)(1)(ii)(A).

administrative burden. First, we are not aware that there is any meaningful compliance risk in the application of the existing eyeball test. It provides an objective test that is easy to apply. Second, while corporate resolutions may be routinely requested, they are not always obtained since there is at present no economic consequence to a payee that fails to provide one. Further, where a payor knows the individuals with authority to act on behalf of the legal entity and there is no perceived business risk, the submission of a corporate resolution may be waived. Thus, by requiring a corporate resolution or other documentation, the Proposed Regulations significantly increase the administrative burden imposed upon payors. Third, we believe that to require a foreign corporation to obtain an EIN to establish an exemption from information reporting on Form 1099 when one is generally not required to avoid withholding on payments of portfolio interest or dividends on publicly traded stocks is to create an unfair burden on foreign corporations. Furthermore, the EIN requirement places U.S. payors at a competitive disadvantage with non-U.S. payors in the custody business who may generally make payments of foreign source income to foreign persons without being required to file information returns.

For these reasons, we recommend that the eyeball test for corporations be retained in the final regulations for all types of reportable payments. The test should, however, be revised to reflect the possible classification of foreign entities as partnerships, whether under present law or under the proposed check-the-box regulations. If the proposed check-the-box regulations are adopted, we would recommend that any per se foreign corporations be treated as exempt recipients for purposes of information reporting on Form 1099.

2. International Organizations as Exempt Recipients. A payor may treat an international organization, agency or instrumentality as an exempt recipient, without requiring a certificate, if such organization is designated as an international organization by executive order.[107] Unlike the current regulations, the Proposed Regulations omit a current list of such organizations. The Preamble to the Proposed Regulations indicates that this omission is intended as a simplification measure. While this is true as a matter of regulatory simplification, the effect of this provision would be to require that each payor independently research executive orders to identify individually designated international organizations. We therefore recommend that the list of international organizations be reinstated in the final regulations in order to provide certainty and consistency among payors as to the identification of international organizations. Further, we recommend that executive orders pertaining to international organizations be announced by the Service as issued.

## XVI. Rules regarding bearer form obligations.

### A. In General.

Generally, the Proposed Regulations retain the current rules regarding bearer obligations, including the rules with respect to the portfolio interest exemption and the exception from information reporting and backup withholding with respect to foreign targeted bearer obligations. Rules providing an exemption from backup withholding tax for bearer obligations generally have been relocated to the provisions providing an exemption from information reporting, thereby providing an exemption from backup

[107] Prop. Reg. § 1.6049-4(c)(1)(ii)(G).

withholding as well. With respect to such rules, we commend the Service for the proposed removal of Temp. Regs. § 35a.9999-1 through 3A and 35a.9999-4T and the cumbersome question and answer format contained therein. However, the Proposed Regulations' treatment of Temp. Regs. § 35a.9999-5 is the cause of confusion in light of the general incorporation of such rules in the Proposed Regulations.[108]/ For example, the retention of Q&A 1 of Temp. Regs. § 35a.9999-5 (a) by cross-reference in Prop. Regs. § 1.871-14(b)(1) is necessary to describe the conditions that must be satisfied for interest on a bearer obligation to qualify as portfolio interest. Yet, the retention of Q&A 2 through 7 of Temp. Regs. § 35a.9999-5(a) is problematic since the rules of such provisions have been incorporated in the Proposed Regulations, with modifications in certain cases. To avoid confusion, the provisions of Temp. Regs. § 35a.9999-5 should be fully incorporated into the relevant provisions of the regulations under sections 871, 1441 and 6049 (to the extent not inconsistent therewith) and should be removed to the extent not so incorporated.

### B. Short-term Bearer Obligations.

Proposed Regs. § 1.6049-5 generally incorporates the special rules regarding the issuance of short-term bearer debt obligations currently contained in Q&A 5 & 6 of Temp. Regs. § 35a.9999-5(a)("Q&A 5 & 6"). Q&A 5 & 6 generally provide that United States source interest on bank deposits with a maturity of one year or less, and on original issue discount obligations that is payable six months or less from the date of original issue,

[108]/ In several cases, subsections of the Proposed Regulations are reserved and specific provisions of Regs. §35a.9999-5 are cross-referenced "for further guidance."

will not be subject to information reporting or backup withholding if the conditions of Q&A 5 & 6 are met. The conditions of Q&A 5 & 6 are (i) the payment is made outside the United States; (ii) the face amount of the obligation is not less than $500,000 (determined by reference to the spot rate on the date of issuance, in the case of an obligation not denominated in United States dollars); (iii) the obligation satisfies the requirements of section 163(f) (2) (B) (i),[109]/ and (ii) (I) except that an original issue discount obligation with a maturity of 183 days or less from the date of issuance is not required to satisfy the certification requirement of Treas. Regs. § 1.163-5(c)(2)(i)(D)(3); (iv) if the obligation is in registered form, it is registered in the name of an "exempt recipient" (as described in Treas. Regs. § 1.6049-4(c) (1) (ii)); and (v) the obligation contains the following legend (or a similar statement having the same effect): "By accepting this obligation, the holder represents and warrants that it is not a United States person (other than an exempt recipient described in section 6049(b)(4) of the Internal Revenue Code and the regulations thereunder) and that it is not acting for or on behalf of a United States person (other than an exempt recipient described in section 6049(b)(4) of the Internal Revenue Code and the regulations thereunder)."

The provisions of Prop. Regs. § 1.6049-5, though, appear to be derived from the language of the 1988 version of Proposed Treas. Regs. § 1.6049-5 rather than the language of Q&A 5 & 6 (which were amended in 1990 in connection with the issuance of

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[109]/ Section 163(f)(2)(B)(i) of the Code requires the existence of arrangements reasonably designed to ensure that such obligation will be sold only to a person who is not a United States person, other than certain United States financial institutions (i.e., the "C Rules" or "D Rules").

the D Rules). Accordingly, certain technical revisions that were made to Q&A 5 & 6 in 1990 are absent from the Prop. Regs. § 1.6049-5 and should be incorporated in final regulations. First, the exception from the certification requirement of the D Rules contained in Q&A 5 & 6 for obligations with a maturity of 183 days or less has been omitted from Prop. Regs. § 1.6049-5. Since it is not feasible to collect ownership certificates with respect to Euro-commercial paper and other short-term bearer instruments, the adoption of the Proposed Regulations without such exception would cause short-term bearer obligations issued outside the United States to become subject to information reporting and backup withholding requirements and thus in some cases could deny access by U.S. issuers of such instruments to a significant source of capital.

In addition, as noted in the 1989 Report, we see no reason for a $500,000 minimum denomination requirement with respect to the issuance of United States source short-term bearer obligations.[110]/ We understand that such requirement is intended to ensure that short-term bearer obligations will not be purchased by United States individuals since the market for obligations with a minimum denomination of $500,000 is limited to the commercial paper market which is comprised primarily of financial institutions. We also understand that the Service's concern is heightened by the fact that the issuer and holder sanctions of sections 4701, 165 (j) and 1287(a) do not apply to such obligations. However, the issuer and holder sanctions similarly do not apply to obligations with a maturity of between 184 days and one year and such obligations may be issued in denominations of less than $500,000.

[110]/ The $500,000 minimum denomination requirement is included in Prop. Regs. § 1.6049-5.

A similar issue exists with respect to so-called "targeted offshore offerings" pursuant to Treas. Regs. § 1.163-5(c)(2)(i)(D)(3)(iii) ("Targeted Offshore Offerings").[111]/ While such rules create a separate class of obligations issued in countries in which the collection of certificates of non-United States beneficial ownership is not permissible, short-term obligations issued under such rules must comply with the requirements of Q&A 5 & 6 (and the Proposed Regulations for payments after December 31, 1997) in order to be exempt from information reporting and backup withholding requirements. Accordingly, Targeted Offshore Offerings of bearer obligations with a maturity of 183 days or less must be issued in minimum denominations of $500,000 or less while such obligations with maturities of 184 days or more do not require minimum denominations of $500,000. Finally, the requirement of $500,000 minimum denominations with respect to the exception from information reporting for payments of bank deposit interest on bearer obligations to Canadian nonresident alien individuals makes such exception unworkable since such minimum denominations

[111]/ The Targeted Offshore Offering exception provides an exception to the certification requirement of the D Rules for obligations issued in foreign countries designated by the Service as a country in which certification is not permissible. To qualify for such exception, the following additional requirements must be satisfied: (i) the interest and principal with respect to the obligation are denominated only in the currency of a single foreign country; (ii) the interest and principal with respect to the obligation are payable only within that foreign country; (iii) the obligation is offered and sold in accordance with practices and documentation customary in that foreign country; (iv) the distributor covenants to use reasonable efforts to sell the obligation within that foreign country; (v) the obligation is not listed, or the subject of an application for listing, on an exchange located outside the foreign country; (vi) the issuance of the obligation is subject to guidelines or restrictions imposed by governmental, banking or securities authorities in that foreign country; and (vii) more than 80% by value of the obligations included in the offering of which the obligation is a part are offered and sold to non-distributors by distributors maintaining an office located in that foreign country.

are prohibitive for individuals. The Service has acknowledged this by imposing the $500,000 minimum denomination requirement in order to keep short-term bearer obligations out of the hands of United States individuals. Thus, such requirement should be eliminated.

Finally, the language contained in Q&A 5 & 6 regarding the determination of the $500,000 minimum denomination requirement with respect to foreign currency-denominated obligations has been omitted from Prop. Regs. § 1.6049-5(b)(10) and (11)(ii). If such $500,000 minimum denomination requirement is retained in final regulations, language should be added to provide that the $500,000 minimum denomination requirement should be "determined by reference to the spot rate on the date of issuance, in the case of an obligation not denominated in United States dollars."

## XVII. Issues not covered by the Proposed Regulations.

Although comprehensive, the Proposed Regulations do not address a number of issues that we believe should be included in any revision of the withholding tax rules.

(a) TEFRA. These include issues relating to the issuance and ownership of bearer bonds, some of which have been addressed in prior Tax Section reports.

1. Convertible Obligations. Consistent with our 1989 report[112]/, we recommend that registered form obligations

[112]/ NYSBA Tax Section Report on the Proposed Regulations Concerning the Issuance of Bearer Form Debt Obligations, dated October 5, 1989, reprinted in Tax Notes Today, Tuesday, October 17, 1989.

that may be converted into bearer form obligations be treated as in registered form if the specific procedures set out below are followed.

Prop. Regs. § 1.871-14(b)(2) states: "Convertible Obligations. [Reserved] For further guidance, see §35a.9999-5 (c), Answers 18 and 19." The last sentence of Q&A 18 states:

> An obligation issued after September 21, 1984, that would otherwise be in registered form but for the fact that it is convertible into bearer form shall be considered to be issued in bearer form. See A-l of §35a.9999-5(a) concerning the conditions that must be satisfied for interest with respect to a bearer obligation to qualify as portfolio interest.

At the time it proposed the D Rules (i.e., Treas. Regs. § 1.163-5(c)(2)(i)(D)), the Internal Revenue Service asked for comments on the feasibility of allowing the issuance in the United States of registered form obligations that might be converted into bearer obligations ("Convertible Registered Obligations"). In our 1989 report, we recommended that Convertible Registered Obligations be permitted to be issued under procedures designed to safeguard the policies underlying TEFRA. In the preamble to the final D Rules, however, the Service stated that "[b]ecause of general tax compliance concerns, it has been decided to continue current law, which treats such convertible obligations as being in bearer form at the time of issuance".

We hope that the "reserved" language of Prop. Regs. § 1.871-14 (b)(2) evidences a willingness on the part of the

Treasury Department and the Service to reconsider this issue and we reiterate our support for the treatment of Convertible Registered Obligations as registered, rather than bearer, obligations for U.S. federal income tax purposes if certain procedures are followed.[113]/

Permitting the simultaneous issuance of Convertible Registered Obligations in the United States and bearer obligations outside the United States in a single offering would make such obligations "fungible" and permit their sale between the two markets. The inability of U.S. issuers to offer fungible debt obligations globally puts them at a disadvantage to foreign issuers, which in many cases may make global offerings of registered form obligations under arrangements which effectively assure non-U.S. holders of the same anonymity provided by bearer form obligations.[114]/

Any potential for abuse in connection with the issuance of Convertible Registered Obligations can be prevented by requiring compliance with the procedures set forth below.

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[113]/ We note that the original Treasury Regulations issued in 1982 under section 163(f)(2)(B) of the Code, also reserved on the treatment of Convertible Registered Obligations. Proposed Treasury Regulations issued on September 2, 1983 treated a Convertible Registered Obligation as a registered obligation if (i) it was part of a larger offering that included bearer obligations issued under procedures reasonably designed to ensure that such obligations would not be sold to United States persons, (ii) the converted bearer obligations met the requirements of section 163(f)(2)(B)(ii) and (iii) the delivery of a converted bearer obligation was conditioned on the delivery by the holder of a certificate of non-United States beneficial ownership. On August 22, 1984, Temporary Treasury Regulations were issued which treated Convertible Registered Obligations as bearer obligations, which treatment is continued under current law.

[114]/ See PLR 9343019 (July 29, 1993) and PLR 934018 (July 29, 1993). Although U.S. issuers can offer fungible registered form debt globally, the Form W-8 requirements applicable to such debt make it unattractive to non-U.S. investors.

Accordingly, we recommend that Prop. Regs. § 1.871-14(b) be modified to permit the offer and sale of Convertible Registered Obligations within the United States and to United States persons if there are “arrangements reasonably designed” to ensure that the bearer obligations into which such Convertible Registered Obligations are convertible (“Converted Bearer Obligations”) will not be sold to United States persons (other than certain financial institutions), and that United States persons may not convert such Convertible Registered Obligations into bearer obligations. The Proposed Regulations should provide that, if such arrangements exist, the offer and sale of Convertible Registered Obligations, and the conversion of such Convertible Registered Obligations into Converted Bearer Obligations, would not (i) subject the issuer of such obligations to the excise tax imposed by section 4701 of the Code or the loss of the deductibility of interest on such obligations, (ii) result in the loss of the portfolio interest exemption from U.S. withholding tax with respect to such obligations or (iii) subject holders of such obligations to the sanctions imposed by Sections 165(j) and 1287(a) of the Code.

Specifically, we recommend that Regs. § 1.163-5(c)(2) and Temp. Regs. § 35a.9999-5(c), Q&A 18 be amended to provide that a Convertible Registered Obligation will be treated as a registered obligation for purposes of Section 163(f)(2)(B) if the following procedures are satisfied.[115]/

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[115]/ In addition, Regs. § 5f.103-1(e) (2) (which provides rules for determining whether an obligation has been issued in registered form) should be amended to provide that Convertible Registered Obligations issued according to such procedures will be treated as registered obligations for U.S. federal income tax purposes.

(1) the Convertible Registered obligation may be converted into bearer form only (i) at an office of the issuer or an exchange agent thereof (an “Exchange Agent”) outside the United States and its possessions and (ii) upon receipt by the issuer or such Exchange Agent of an ownership certificate meeting the requirements of Regs. § 1.163-5(c)(2)(i)(D)(3). For purposes of this paragraph, the conversion of a Convertible Registered Obligation should be considered to take place outside the United States and its possessions notwithstanding that such Convertible Registered Obligation is delivered to the issuer or its Exchange Agent, or that the book-entry system that reflects the Convertible Registered Obligation is maintained, in the United States or its possessions, provided that the Converted Bearer Obligation is delivered outside the United States and its possessions;

(2) if the Convertible Registered Obligation is presented for conversion during the restricted period with respect to an offering (i.e., during the period in which such obligations are represented by a temporary global security), the holder would be entitled to delivery of a Converted Bearer Obligation only upon the delivery by such holder of an ownership certificate described in Regs. § 1.163-5(c)(2)(i)(D)(3);

(3) the Converted Bearer Obligation must meet the requirements of Regs. § 1.163-5 (c)(1)(ii), which provides that the interest on such obligation must be payable only outside the United States and its possessions and a legend must be placed on the face of such obligation, or any coupon appertaining thereto, to the effect that any United States person who holds such obligation will be subject to limitations under United States income tax laws, including the limitations provided in Sections 165 (j) and 1287(a) of the Code; and

(4) if any distributor of bearer obligations that are a part of the offering that includes Convertible Registered Obligations acquires a Converted Bearer Obligation during the restricted period, such distributor must comply with the D Rules with respect to the offer, sale and delivery of such Converted Bearer Obligation.

These procedures would effectively treat the conversion of a Convertible Registered Obligation as a reissuance of such obligation in bearer form and would be designed to ensure that such Converted Bearer Obligation would be distributed only to non-United States persons (other than certain financial institutions) outside the United States and its possessions. Such restrictions mirror the requirements of the D Rules and would treat Converted Bearer Obligations in the same manner as bearer obligations in a primary offering or distribution thereof.

Since such Convertible Registered Obligations would be considered to be in registered form for U.S. federal income tax purposes prior to the conversion of such obligations, such obligations should be subject to the rules regarding registered obligations for the period prior to conversion. We believe that this is the appropriate rule since the owners of such Convertible Registered Obligations prior to conversion will be recorded on the registry with respect to the obligations during such period. Accordingly, none of the abuses targeted by TEFRA exist with respect to Convertible Registered Obligations during such period. In addition, such procedures should permit the conversion of Convertible Registered Obligations into targeted registered form obligations (at least in situations where a portion of the original offering was issued in targeted registered form), assuming that the procedures similar to those described above are satisfied.

2. <u>Section 165 (j)</u>.

(i) <u>Generally</u>. Section 165 (j) of the Code provides that no deduction is permitted in respect of any loss sustained on any registration-required obligation unless such obligation is in registered form (or the issuance of such obligation was subject to the excise tax imposed by Section 4701 of the Code). Exceptions are provided under sections 165(j)(3), though, which states:

> The Secretary may, by regulations, provide that this subsection and section 1287 shall not apply with respect to obligations held by any person if --
>
> (A) such person holds such obligations in connection with a trade or business outside the United States;
>
> (B) such person holds such obligations as a broker dealer (registered under Federal or State law) for sale to customers in the ordinary course of his trade or business;
>
> (C) such person complies with reporting requirements with respect to ownership, transfers, and payments as the Secretary may require; or
>
> (D) such person promptly surrenders the obligation to the issuer for the issuance of a new obligation in registered form,
>
> but only if such obligations are held under arrangements provided in regulations or otherwise which are designed to assure that such obligations are not delivered to any United States person other than a person described in subparagraph (A), (B), or (C).

Regs. § 1.165-12(c) provides the rules describing such arrangements.

The Proposed Regulations amend Treas. Regs. §1.165-12(c)(1)(iv) to eliminate the requirement that, in connection with the delivery of a bearer obligation, the holder receive a statement from the purchaser that states that the purchaser is a financial institution that is purchasing for its own account or for the account of another financial institution or exempt organization that will comply with the requirements of Section 165(j)(3)(A), (B) or (C) and that the holder has no actual knowledge that the statement is false.

We welcome this change since the certification requirement was an administrative burden that disrupted the trading of bearer obligations. We recommend certain other clarifying changes to Regs. § 1.165-12(c), however, as follows:

(ii) Clarifying Chancres. (a) The $1 million minimum denomination requirement of Treas. Regs. § 1.165-12(c)(1)(ii) should be deleted in order to conform that provision to Treas. Regs. § 1.165-12(c) (3) (iii). Treas. Regs. § 1.165-12(c)(1)(ii) should be revised to read as follows:

> In the case of a bearer obligation (A) the holder must offer, sell and deliver such obligation outside the United States and its possessions or (B) in the case of a holder described in paragraph (c) (1) (i), the holder may offer, sell and deliver such obligation in the United States and its possessions if such offer, sale and delivery is to another financial institution for its own account or for the account of an exempt organization as defined in section 501 of the Code.

(b) The provisions of Regs. § 1.165-12 (c) which cross-reference Regs. § 1.165-12 (c)(1)(iv) should be amended to refer to Regs. § 1.165-12(c) (1) (iii) instead since the Proposed Regulations would delete subsection (iii) and redesignate subsection (iv) as subsection (iii). Such cross-references appear in each of Regs. §§ 1.165-12(c) (2) (iv) and 1.165-12(c)(3)(iv).

(c) The following sentence should be added at the beginning of Regs. § 1.165-12 (c)(1) to clarify that the requirements of each of clauses (i) through (iii) of such section are required to avoid holder sanctions: “The holder is a person that satisfies the conditions set forth in subdivisions (i), (ii) and (iii) of this paragraph (c)(1).”

(d) In order to coordinate the language of Regs. § 1.165-12 (c) with the language of the C Rules and D Rules, references to sales inside the “United States” or outside the “United States,” as the case may be, should be changed to references to sales inside or outside the “United States and its possessions.”

3. Miscellaneous Changes to the Rules Regarding Bearer Obligations

(i) Qualifying Foreign Branches. Treas. Regs. 1.163-5(c)(2)(i)(D)(B) and § 1.163-5 (c)(2)(i)(D)(6) provide rules under which a foreign branch of a United States financial institution may purchase bearer obligations upon their original distribution. As noted above, though, the United States offices of a United States or foreign financial institution may hold bearer obligations in compliance with section 165(j)(3)(A),(B) or (C) of the Code and the Treasury Regulations issued thereunder. In fact, the provisions of Regs. § 1.163-5(c)(2)(i)(B) (the "B Rules"), which were effective for bearer obligations issued on or before September 7, 1990, permitted sales to any financial institution that agreed to comply with the requirements of Section 165(j)(3)(A),(B) or (C) of the Code and the regulations issued thereunder. The version of the D Rules that was proposed on August 24, 1989, also permitted sales to United States financial institutions even if such sale was to the United States office of such financial institution.[116]/ Accordingly, we recommend that these rules be revised to permit a "financial institution" rather than "the foreign branch of a United States financial institution" as a permissible purchaser, at least where the purchase by the financial institution takes place outside the United States.

(ii) Payments Outside the United States. Regs. § 1.163-5(c)(2)(v) provides rules regarding the treatment of payments as payable only outside the United States for purposes of the C Rules and the D Rules. Such section contains the following exception:

> Interest will be considered payable outside the United States and its possessions notwithstanding that such interest may become payable at the office of the issuer or its United States paying agent under the following conditions: the issuer has appointed paying agents outside the United States and its possessions with the reasonable expectation that such paying agents will be able to pay the interest in United

[116]/ See Prop. Regs. § 1.163-5(c)(2)(i)(D)(10), INTL-0536-89, 54 Fed. Reg. 35200 (Aug. 24, 1989).

> States dollars, and the full amount of such payment at the offices of all such paying agents is illegal or effectively precluded because of the imposition of exchange controls or other similar restrictions on the full payment or receipt of interest in United States dollars. [emphasis added].

As the highlighted language indicates, such exception applies only to payments denominated in United States dollars. However, the policy underlying such exception is not contingent on payments being denominated in United States dollars -- if payments outside the United States become illegal, payments within the United States should be permissible. In fact, market practice is to provide for such an exception even if payments are denominated in a foreign currency since, as unlikely as the applicability of such exception may be, investors are hard pressed to accept no payment in such a situation. The Service apparently agrees with such position since the interest payment rule enacted as a part of the targeted offshore offerings component of the D Rules[117]/ allows (by cross-reference) payments to be made within the United States if they become illegal or effectively precluded because of the imposition of exchange controls or other similar restrictions. Payments of interest with respect to targeted offshore offerings must be denominated in the currency of a single foreign country. Therefore, we recommend the deletion of the highlighted language of Treas. Regs. § 1.163-5(c)(2)(v) cited above that requires such interest payments to be denominated in United States dollars in order to be payable within the United States.

[117]/ Treas. Regs. § 1.163-5(c)(2)(i)(D)(3)(iii).

(iii) DTC/Euroclear/CEDEL Global Registered Notes. Regs. § 5f.103-1(e)(2) provides rules for determining when an obligation will be considered to be issued in registered form. It would be helpful if such rules were amended to clarify that a permanent global note registered in the name of the Depositary Trust Company, Euroclear or Cedel (or other nominees) will be considered to be a registered obligation for U.S. federal income tax purposes and that such depositaries are "payees" for information reporting and backup withholding tax purposes. The terms of such obligations provide that transfers can only be made for the accounts of participants through the book-entry systems maintained by such organizations. Such an amendment would be consistent with market practice and certain private letter rulings issued by the Service.[118]

(iv) DTC/Euroclear/CEDEL Global Bearer Notes. Reg. § 1.163-5(c)(2)(i)(D)(3) describes the procedures required for the initial certification of foreign ownership of foreign targeted bearer debt. The flush language of clause (i) thereof states that the certification requirements are not satisfied if the issuer does not make the obligation available for delivery in definitive form within a reasonable period after the end of the restricted period.

This language permits an arrangement under which the issuer issues a definitive global bearer bond to a clearing agency, with an investor having the choice of continuing to hold its interest through the clearing agency or else withdrawing its share of the global bond in the form of a definitive bearer bond. There is uncertainty, however, as to whether the same

[118]/ See PLR 9343018 (July 29, 1993); PLR 9343019 (July 29, 1993); PLR 8842051 (January 27, 1988).

arrangement would be permitted if the investor cannot withdraw a definitive bearer bond from the clearing agency (although withdrawal would be automatic if the clearing agency ceased doing business). Many issuers would prefer this approach because it avoids the expense of printing definitive bearer bonds, particularly since Euroclear and CEDEL do not allow partial issuance of definitive notes. There seems to be no good reason not to allow this, and we urge that the regulations be amended accordingly.