Boston University School of Law

Scholarly Commons at Boston University School of Law

Faculty Scholarship

1986

American Income Tax Aspects of Trans-Border Securities Investment

William W. Park
Boston University School of Law

Follow this and additional works at: https://scholarship.law.bu.edu/faculty_scholarship

Part of the Property Law and Real Estate Commons

Recommended Citation

William W. Park, *American Income Tax Aspects of Trans-Border Securities Investment* , *in* 4 Boston University International Law Journal 67 (1986).
Available at: https://scholarship.law.bu.edu/faculty_scholarship/2263

This Article is brought to you for free and open access by Scholarly Commons at Boston University School of Law. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Scholarly Commons at Boston University School of Law. For more information, please contact lawlessa@bu.edu.

AMERICAN INCOME TAX ASPECTS OF TRANS-BORDER SECURITIES INVESTMENT

WILLIAM W. PARK

William W. Park is Professor of Law at Boston University and Adjunct Professor of International Law at the Fletcher School of Law and Diplomacy. He has been a Fellow at Selwyn College, Cambridge, and a Visiting Professor of Law at the University of Dijon. A graduate of Yale and Columbia, Professor Park practiced law in Paris for five years and served for two years as legal advisor to a bank in Geneva. He is a member of the Massachusetts and District of Columbia Bars.

INTRODUCTION

Encouraging investment of foreign capital in securities issued by American companies does not always marry well with preserving the integrity of the tax system. The interaction between the anonymity sought by some foreign investors and the disclosure required to enforce the law reminds one of the prophet Ezekiel's vision of a wheel within a wheel,[1] and Shakespeare's *Hamlet,* which contains a play within a play.[2] For today's topic—which claims neither the elegance of Shakespeare's drama nor the obscure fascination of Ezekiel's vision—contains a problem within a problem.

The foreigner's problem of determining tax liability in the country of income source—paying a tax or not paying a tax in the United States—contains within it the problem of avoiding disclosure of income or assets which, in order to evade tax or exchange control laws, may not have been declared to the authorities in his home country.

Imagine, if you will, someone in a country with exchange controls,[3] such as France and Italy, who has decided to diversify his portfolio illegally by holding British or American securities through a secrecy screen involving a Panama company and a nominee Swiss bank. If the investor is not declaring the assets or reporting the income in his country of residence, he will be

© William W. Park, 1986.

1 ". . . their appearance and their work was as it were a wheel in the middle of a wheel." *Ezekiel* 1:16.

2 Planning to use *The Murder of Gonzago* to catch his father's assassin, Hamlet declares, "The play's the thing, wherein I'll catch the conscience of the King." Shakespeare, *Hamlet,* Act II, Scene II, line 608-09.

3 Exchange control regulations play a significant role in the financial policy of many nations. Typically they prohibit residents from keeping foreign bank accounts or assets denominated in foreign currency unless authorized by the central bank. A survey of exchange regulations is found in PRICE WATERHOUSE, FOREIGN EXCHANGE INFORMATION—A WORLDWIDE SUMMARY (1982).

concerned about how the British or American tax collection process will affect the anonymity of the ownership of these securities. The concern about confidentiality may be as great as the concern about the tax rate on the dividends, interest and capital gains. A requirement, for example, that Swiss banks collecting interest on bonds of American issuers disclose to the Internal Revenue Service the ultimate beneficial owner of the bonds may be as significant to the owner as the rate of withholding tax on the interest.[4] A British investigation into the ultimate beneficial ownership of Panamanian companies holding securities deposited with British banks[5] may cause as much concern as do the provisions of the law imposing tax. The Italian who learns that his holding company in Panama is subject to a British tax investigation relating to assets that are illegally held abroad may be as concerned about disclosure in Italy, either through official or unofficial channels, as he is about tax in Britain.

The impact of the tax collection process on anonymity exerts a subtle, yet powerful, influence on patterns of transborder securities investments by many Europeans, Middle Easterners, Africans and South Americans. Their attempt to avoid both tax and disclosure may seem like trying to lose weight without going on a diet. But the volatile nature of a geographically mobile market suggests that transactions can be, and are, structured to achieve both goals.

The very nature of secrecy frustrates any comprehensive assessment of its influence as a motivating factor in tax planning for international securities investments. The themes of confidentiality and anonymity enter scholarly analysis of international tax issues in a tantalizing, yet intrinsically indeterminate fashion, and elude any systematic approach or conclusions.

The prospects for closer ties between the London and New York Stock

---

[4] *See infra* notes 15-32 and accompanying text.

[5] Such investigation might arise in connection with British Income and Corporation Tax Act, 1970, § 159(3) which applies to payments to "any persons in the United Kingdom":

> Where—
> (a) a banker or any other person in the United Kingdom, by means of coupons received from any other person or otherwise on his behalf, obtains payments of any foreign dividends elsewhere than in the United Kingdom, or
> (b) any banker in the United Kingdom sells or otherwise realises coupons for foreign dividends, and pays over the proceeds to any person or carries them to his account, or
> (c) any dealer in coupons in the United Kingdom purchases any such coupons otherwise than from a banker or another dealer in coupons, tax under Schedule D shall extend, in the case mentioned in paragraph (a) above, to the dividends, and, in the cases mentioned in paragraphs (b) and (c) above, to the proceeds of the sale or other realisation, and income tax shall be assessed and charged and paid under this subsection in accordance with Parts III and IV of Schedule 5 to this Act.

"Foreign dividends" are defined to include interest on securities.

Exchanges, and the expected increase in transborder capital raising[6] and securities trading,[7] make this an appropriate occasion to re-examine selected tax issues related to transborder trading and investment in securities.

Invariably, one feels frustrated in attempting a summary or an overview of such a vast and slippery topic. The particular facts and circumstances of each transaction, which may differ greatly, are the variables that determine tax consequences of the divergent transactions. Brevity requires selection, which requires subjectivity. Yet a rough sketch is usually better than a blank page—or a silent hour. This thumbnail sketch, of how the United States taxes non-resident investors, and of how Americans obtain credit for taxes paid abroad, aims merely to flag issues that would reward attention by investors and their advisors.

I. "INBOUND" INVESTMENT—THE FOREIGN TAXPAYER[8]

A. *The Statutory Framework*[9]

As a general rule, a foreign person is taxable in the United States at a flat rate of thirty percent (30%) on United States source dividends and interest, but not on capital gains, whether United States source or foreign source, provided he, she or it is not engaged in a trade or business within the United States.[10] In the case of a non-resident alien, the individual must be present in the United States for less than six months (183 days) out of the year.[11]

The test for determining whether an alien is non-resident must be dealt with as part and parcel of each individual's tax planning. Almost invariably,

---

[6] Recently, many small companies in the Boston area have turned to London to raise capital on London's Unlisted Securities Market. *See Raising Cash in London,* Boston Globe, Dec. 30, 1985, at 11, col. 2.

[7] Salomon Brothers, Inc. estimates that foreigners will increase their holdings of U.S. securities by $83.4 billion this year to about $480 billion. Sesit, *Foreigners Are Seen Continuing Big Investments in U.S. Markets,* Wall St. J., Jan. 2, 1986, at 6B, col. 4.

[8] The discussion herein deals with income tax considerations. The alien may also be concerned about estate and gift tax. The taxable gross estate of a non-resident alien includes property with a U.S. situs. I.R.C. § 2103. Stock is deemed to have a U.S. situs if issued by a domestic corporation. I.R.C. § 2104(a). Gift tax also applies only to stock and debt of a U.S. issuer. I.R.C. § 2511. For estate and gift tax purposes residents include only domiciliaries, i.e., persons with the intent to remain in the U.S. indefinitely. *See* Treas. Reg. § 20.0-1(b). *Cf.* the definition of residence for income tax purposes under I.R.C. § 7701(b).

[9] For a general survey of the subject, see Granwell & Wold, *U.S. Taxation of Foreign Investment in Stocks, Securities and Commodities,* 1981 TAX MGMT. INT'L J. 15.

[10] I.R.C. § 871 and § 881.

[11] I.R.C. § 871(a)(2).

maintaining non-resident status under the recently adopted "mechanical" tests of I.R.C. § 7701(b) requires an alien to stay outside the United States for more than half the year.[12] Corporate entities' tax status is determined by reference to the place of incorporation.[13]

With respect to dividends and interest, concern has focused on preservation of the anonymity of the investor who benefits from rate reduction under treaties or from the statutory exemption on what is called "portfolio interest" on bonds.[14] The critical question with respect to capital gains is what constitutes a "trade or business" conducted within the United States.

B. *Dividends and Interest*

1. Portfolio Interest

Generally, a non-resident alien or foreign corporation is subject to tax at a thirty percent (30%) flat rate on receipts of United States source "fixed and determinable annual or periodical gains," which includes dividends and interest from a United States corporation,[15] if not effectively connected to a United States business or accorded the benefits of an income tax treaty.[16]

In the summer of 1984, Congress abolished the tax on what is called "portfolio interest," which includes interest either on registered bonds with respect to which the payor of interest has received a statement that the

---

[12] I.R.C. § 7701(b). If an alien is present in the U.S. on fewer than 183 days during the year, and has a tax home in a foreign country with which he has a closer connection than to the U.S., he will generally be treated as a non-resident alien if he has not been lawfully admitted for permanent residence (i.e., does not have a "green card").

If the alien is unable to establish a closer connection to a foreign country, then he must be in the U.S. for less than 183 days over the course of three years, using a weighted formula counting current year days as 1, immediate preceding year days as 1/3 and second preceding year days as 1/6.

Special rules exist for individuals present in the U.S. for medical conditions arising while in the country, foreign government-related individuals, teachers, trainees, and students. Treaty "tie-breaking" rules may also provide an exception to this general rule.

[13] I.R.C. § 7701(a)(4).

[14] I.R.C. § 871(h)(3) and § 881(c)(3).

[15] Dividends and interest from a domestic corporation will be foreign source only if less than twenty percent (20%) of the paying corporation's gross income is from U.S. sources. I.R.C. § 861(a). Dividends and interest from a foreign company will be U.S. source only if at least half of the distributing company's income is effectively connected to a U.S. business. I.R.C. § 861(a).

[16] "Effectively connected" dividends and interest are subject to tax at normal progessive rates. Special rules govern original issue discount (OID) obligations. I.R.C. § 871(g). The Code distinguishes between short-term obligations, payable less than six months from date of issue, and longer term obligations. OID on the latter is taxable if accruing during period held by investor.

beneficial owner is a foreign person, or bearer bonds that are "foreign targeted." The repeal of tax on portfolio interest is part of the country's effort to attract foreign capital.

Bearer obligations will be considered foreign targeted if subject to arrangements reasonably designed to ensure that they will be sold only to non-Americans, if interest is payable outside the United States, and if the security bears a legend on its face describing the tax limitations (such as denial of loss deductions or capital gain treatment) imposed on Americans holding the bond.[17] Portfolio interest does not include interest received by banks on loans concluded in the ordinary course of their business, or by shareholders owning ten percent (10%) or more of the voting power of the corporation that issued the bond.[18]

Repeal of the thirty percent (30%) source withholding tax on portfolio interest has reshaped the Eurodollar bond market, reportedly bringing rates on Eurodollar and United States domestic bond issues closer together,[19] and perhaps directing funds to the United States at the expense of developing nations competing for the same capital.

Repeal was intended to attract foreign investors to United States debt securities, but not to facilitate tax avoidance by Americans using nominee foreign banks. Therefore the United States has a legitimate interest in information reporting[20] of "window payments" of bond interest, received for and paid to customers by banks acting as nominees. Yet this reporting might have decreased the attractiveness of bearer bonds to non-resident aliens seeking to guard their anonymity. Information reporting dovetails into the twenty percent (20%) "backup withholding" on American tax evaders.[21] Ironically, foreign fears focused on reporting requirements designed to catch domestic—not foreign—tax evaders.[22]

After Swiss and German banks expressed hesitation about buying these American issued bearer bonds for their customers, the Temporary Treasury Regulations issued in late August 1984 interpreted the information reporting requirements to apply with respect to interest on bearer bonds paid by a foreign bank only if it is a "controlled foreign corporation" (a term of art indicating that more than half of a foreign company's voting stock is

[17] I.R.C. § 163(f)(2)(B); Treas. Reg. § 1.163-5(c).

[18] I.R.C. § 871(h)(3) and § 881(c)(3).

[19] *See e.g.*, Winkler, *U.S. Change in Rule on Withholding Is Reshaping Eurodollar Bond Market*, Wall St. J., May 24, 1985, at 10, col. 1.

[20] I.R.C. § 6049. I.R.C. § 6042 imposes a similar requirement as to dividends. I.R.C. § 6041 requires reporting of "miscellaneous payments" in excess of $600. I.R.C. § 6045 provides that brokers shall file information returns showing the name and address of each customer.

[21] I.R.C. § 3406.

[22] A similar concern arises with respect to British Income and Corporation Tax Act, 1970, § 159. *See supra* note 5.

[23] I.R.C. § 957.

American-controlled)[23] or if at least half of its gross income is effectively connected to a United States trade or business.[24] Thus most foreign owned foreign banks are not subject to the reporting requirements. The American-owned foreign bank, paying interest as nominee or agent on a bearer bond, is required to report the interest payment unless it has documentary evidence that the payee is neither a citizen nor a resident of the United States. These documents could fall into the wrong hands and break the desired anonymity of the bank's customer.

Similar leaks could also occur with respect to interest on deposits with foreign branches of American banks. Although characterized as foreign source[25] and thus not subject to reporting requirements for interest as such,[26] payments of more than $600 would be subject to the "miscellaneous payments" reporting,[27] at least if made to an individual with respect to which the bank has no evidence of foreign status.

The Internal Revenue Service has also stated that for the time being "backup withholding" would not be required for any foreign banks, whether or not United States owned,[28] thus confirming what seemed a reasonable limit on American fiscal jurisdiction, and also reducing one source of tension among allies and trading partners. The dilemma between strict enforcement of tax laws and increasing bearer bond marketability was resolved in favor of marketability.

The dilemma was particularly troublesome because the reporting requirements could have conflicted with foreign secrecy laws.[29] United States

---

[24] Temp. Treas. Reg. § 35a, 9999-4, T.D. 7972, issued August 28, 1984, (adding 'Q&As No. 5' to clarify Temp. Treas. Reg. § 35a; 9999-5.)

[25] I.R.C. § 861 (a)(1)(F). Interest on a deposit with a foreign subsidiary also would be characterized as foreign source unless half or more of its gross income is effectively connected to a U.S. business. I.R.C. § 861 (a)(1)(B). Interest on deposits with domestic branches would be foreign source only if received by a non-resident alien. I.R.C. § 861(a)(1)(A) and § 861(c).

[26] I.R.C. § 6049 (b)(2)(D).

[27] I.R.C. § 6041.

[28] Temp. Treas. Reg. § 35a, 9999-4, T.D. 7972, issued August 28, 1984, (adding 'Q&As No. 5' to clarify Temp. Treas. Reg. § 35a; 9999-5.)

[29] For example, Swiss Federal Banking Law, Art. 47 or Swiss Penal Code, Art. 273. Swiss Banking Law, Art. 47 states:

> Any person who wilfully . . . in his capacity as organ, officer or employee of a bank, as auditor or assistant auditor, as member of the Banking Commission, officer or employee of its secretarial office, violates his duty to observe silence or the professional secrecy, or whoever induces or attempts to induce a person to commit such an offense, shall be fined not more than twenty thousand francs, and/or shall be imprisoned for not longer than six months.
>
> If the offender acted negligently, the penalty is a fine of not more than ten thousand francs.

Swiss Penal Code, Art. 273 states:

> Whoever makes available a manufacturing or business secret to a foreign

courts have enforced United States tax and securities law, despite foreign secrecy legislation, by imposing sanctions on foreign companies that have refused to comply with requests for information contained in subpoenas or administrative summonses.[30] Such unilateral enforcement has proved more effective in tax cases than bilateral measures involving mutual judicial assistance treaties. The treaty with Switzerland normally applies only to tax investigations designed to catch upper echelons of organized crime.[31] The internal Swiss law on mutual assistance applies only to complex tax fraud.[32]

2. Treaty Shopping

Income tax treaties provide another source of conflict between the foreigner's concern for anonymity and the integrity of the American tax sys-

---

governmental agency or a foreign organization or private enterprise or to an agent of any of them, shall be subject to imprisonment and in grave cases to imprisonment in a penitentiary. The imprisonment may be combined with a fine.

[30] In the tax area, *see* United States v. Vetco, Inc., 644 F.2d 1324 (9th Cir.) *amended on rehearing,* 691 F.2d 1281 (9th Cir.), *cert. denied,* 454 U.S. 1098 (1981); Marc Rich & Co. v. United States, 707 F.2d 663 (2d Cir. 1983), *aff'd,* 736 F.2d 864 (2d Cir. 1984); and Garpeg v. United States, 583 F. Supp. 789 (S.D.N.Y. 1984). *See also* S.E.C. v. Banca Della Svizzera Italiana, 92 F.R.D. 111 (S.D.N.Y. 1981) (violation of the Exchange Act of 1934, § 10(b) and § 14(e), 15 U.S.C. § 78j(b), § 78n(e)).

[31] Treaty on Mutual Assistance in Criminal Matters, May 25, 1973, United States-Switzerland, Art. 14, 27 U.S.T. 2019, T.I.A.S. No. 8302, (entered into force in 1977), permits bank secrecy to be lifted. However, the treaty is not applicable to tax crimes except in the context of investigation or prosecutions of figures in the upper echelon of organized crime. [Art. 2(1)(c)(5) and Art. 7(2)]. Conditions for judicial assistance in tax matters involving organized crime figures include: (1) the evidence of crimes committed is insufficient to constitute proof of the crime, (2) the organized crime figure could be put in jail for a period of time long enough to inflict serious harm on the group, and (3) the securing of the information or evidence would be impossible, or unduly burdensome, without the assistance of the other state. *See* W. Park, *Compelling Information from Foreign Corporations: Secrecy Laws and U.S. Economic Regulations,* in INVESTMENTS IN U.S. REAL ESTATE FROM A EUROPEAN PERSPECTIVE 415-17 (R. Zach ed. 1985).

[32] *Loi sur l'Entraide Internationale en Matière Pénale,* March 20, 1981, entry into force January 1, 1983, and Ordonnance d'Execution of February 24, 1982. Characterization of the offense is critical to U.S government attempts to use the domestic Swiss law on assistance in criminal matters. The law excludes from its scope requests relating to tax offenses (Art. 3), except for a narrow category of complex tax fraud: *escroquerie* (or in German *Betrug*), where the reduction in taxes results from what the law terms a "clever posture"—*attitude astucieuse.*

The intentional alteration of documents might constitute an *attitude astucieuse,* but not mere failure to file a return. A taxpayer who files a return supported by a balance sheet containing the erasure of figures, for example, may have committed *escroquerie;* but not so a taxpayer who simply fails to file a return. *Escroquerie* is defined by reference to Art. 14(2) of the *Loi sur le Droit Pénal Administratif* (DPA). See Ordonnance d'Execution of the L.E.I.M.P., Art. 24.

tem. The Swiss-United States income tax treaty, one of thirty-four such treaties to which the United States is party,[33] reduces the tax rate on dividends from thirty percent (30%) to fifteen percent (15%).[34] A resident of a non-treaty country (or residents of treaty countries who may not want their own government to learn of their investment abroad) may try to obtain the benefits of the Swiss treaty by purchasing securities through a nominee Swiss bank.

Such "treaty shopping" obviously undermines the American goal of obtaining reciprocal benefits for American residents and citizens. If non-treaty country residents can use a treaty's provisions, the United States in essence has a "treaty with the world," which reduces the incentive for treaty negotiation by the countries in which these treaty abusers reside.

To keep the treaty from being abused, the United States would like to know the country of residence of the beneficial owners of dividends paid to foreign nominee banks. The customers of these banks, however, may hesitate to disclose their identities to government agencies verifying residence.

With the ingenuity and integrity one expects of the Helvetic people, the Swiss have met the problem, at least in part, by a supplementary withholding tax (*retenue supplémentaire*) applied in the case of a dividend received by a non-resident of Switzerland trading in United States securities through a nominee Swiss bank account.[35] Swiss banks must withhold an additional

---

[33] The U.S. is also a signatory to another eleven treaties, four of which have been approved by the Senate and await exchange of instruments, and seven of which have been signed and await Senate approval. 14 TAX MGMT. INT'L J. 443 (1985).

[34] Income Tax Convention, May 24, 1951, United States-Switzerland, Art. VI, 2 U.S.T. 1751, T.I.A.S. No. 2316, (effective for taxable years after Jan. 1, 1951) states:

> (1) The rate of tax imposed by one of the contracting States upon dividends derived from sources within such State by a resident or corporation or other entity of the other contracting State not having a permanent establishment in the former State shall not exceed 15 percent: Provided, however, that this paragraph shall have no application to Swiss tax in the case of dividends derived from Switzerland by a Swiss citizen (who is not also a citizen of the United States) resident in the United States.
>
> (2) It is agreed, however, that such rate of tax shall not exceed five percent if the shareholder is a corporation controlling, directly or indirectly, at least 95 percent of the entire voting power in the corporation paying the dividend, and if not more than 25 percent of the gross income of such paying corporation is derived from interest and dividends, other than interest and dividends received from its own subsidiary corporations. Such reduction of the rate to five percent shall not apply if the relationship of the two corporations has been arranged or is maintained primarily with the intention of securing such reduced rate.
>
> (3) Switzerland may collect its tax without regard to paragraphs (1) and (2) of this Article but will make refund of the tax so collected in excess of the tax computed at the reduced rates provided in such paragraphs.

[35] *See* Art. 14 Arrêté du Conseil Fédéral, November 2, 1951 and January 20, 1967, and Treas. Reg. § 509.8, T.D. 5867, 1951-2 C.B. 75 with respect to withholding on dividends.

fifteen percent (15%) tax (the difference between the treaty rate of fifteen percent (15%) and the normal thirty percent (30%) withholding), which eventually ends up in Washington. A similar supplement of twenty-five percent (25%) is withheld on interest that would otherwise be taxed.

The Internal Revenue Service in the past has policed treaty abuse on coupon bond interest through Form 1001, which the United States withholding agents must receive before they can apply the treaty rate. The form is filed by the nominee recipient of the interest, not the beneficial owner of the bonds. The information received contains the name and address of the nominal owner of interest, not its ultimate beneficial owner. Since this form does not require documentation about the ultimate beneficial owner, there is a potential for use of treaties by persons not entitled to their benefits.

The obligation to file Form 1001 covers "coupon bond interest," but not dividends. Currently, to obtain treaty benefits on dividends the recipient need show only a foreign address.[36]

The proposed modifications of these Regulations attempt to close these potential avenues for treaty abuse.[37] The proposed Regulations, issued in September 1984, cover dividends as well as interest. The United States withholding agent would have to receive a certificate signed by the competent tax authorities of the treaty partner, certifying the residence in the treaty country of the beneficial owner of the income.[38] The beneficial owner would have to declare, under penalty of perjury, that the information in the certificate is correct.[39]

The "Certificate of Residence" procedure would be less susceptible to abuse than the present procedure, because it would require validation by a competent tax authority of the treaty country. Obviously, this would wipe out the anonymity of the investor. It is not surprising to learn that there have been complaints about such a procedure.[40]

---

[36] Treas. Reg. § 1.1441-6.

[37] The proposals were instigated by the congressional mandate of the Tax Equity and Fiscal Responsibility Act, 1982, § 342.

[38] Proposed Treas. Reg. § 1.1441-6. Form 8306 would require the beneficial owner of the income to provide his or her full name, address in the foreign country in which residency is claimed, a statement that he or she is a resident of such country for purposes of its tax laws and is entitled to benefits under the tax convention between such country and the United States.

[39] One may wonder whether the "penalty of perjury" requirement would matter to foreigners who may not even have an equivalent concept in their language, or whose ethical attitudes towards tax evasion may be more relaxed than our own.

[40] Hearings on the proposed regulations were held on February 22, 1985. Witnesses from the foreign banking and securities industries expressed dissatisfaction with the "Certificate of Residence" procedure. The Securities Industry Association, which represents over 500 securities firms, said in a letter to the Internal Revenue Service that the new certification requirements would "discourage investment in U.S. securities." An advisory panel on international capital markets to the board of

A more workable alternative involves a "refund certification" system, under which the United States payer would withhold the full thirty percent (30%). It would be up to the non-resident alien to obtain a refund of the difference between thirty percent (30%) and the treaty rate. If the alien did not want his anonymity breached, he would not file for a refund with the Internal Revenue Service.

C. *Capital Gains*

When a non-resident alien or foreign corporation sells his or its securities, the gain generally will not be subject to tax, provided the foreign seller is not engaged in a trade or business in the United States and, in the case of an individual, is present in the United States less than 183 days per year.[41] Whether transactions within the United States are sufficient to constitute a "trade or business" is a function of the facts and circumstances of the case. Understanding the "trade or business" concept requires the proverbial page of history as much as the equally proverbial volume of logic. Although a Revenue Ruling says that a single transaction—a horse entered in one race—can constitute a trade or business,[42] normally there must be some progression of regular, continuous, and sustained activity. An active trader might be doing business; but a passive investor who merely owns income producing securities would not.[43]

Intuitively, one has a sense that those who only clip coupons differ from those engaged in buying and selling. As Professor Isenbergh of Chicago has put it, there is a difference between "the activities of those who dig, plow, [and] . . . cajole" and those who "merely remove a check from an envelope with fingers left slender and pale from the absence of toil."[44] Or, as the Fifth Circuit put it, the word "business" implies that one is kept busy.[45] Line drawing, however, has not been simple.

---

directors of the New York Stock Exchange said the proposed rules would erect a barrier to the free flow of capital.

[41] The gain is not "fixed or determinable annual or periodic gain." Treas. Reg. § 1.1441-2(a)(3).

[42] Rev. Rul. 58-63, amplified in Rev. Rul. 60-249, 1960-2 C.B. 264, modified by Rev. Rul. 70-543, 1970-2 C.B. 172, amplified by Rev. Rul. 85-4, 1985-1 C.B. 294.

[43] *See* cases cited in Isenbergh, *The "Trade or Business" of Foreign Taxpayers in the United States,* 61 TAXES 972-980 (1983); Stevenson, *Is the Connection Effective? Through the Maze of Section 864,* 5 NW. J. INT'L L. & BUS. 213, 233-237 (1983); ROBERTS, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NON-RESIDENT ALIENS, V-7 to V-9 (R&W 1966); Roberts, *U.S. Taxation of Foreign Taxpayers' Stock or Security Transactions,* 33 J. TAX'N. 66, 146 (1970); Sitrick, *U.S. Taxation of Stock and Securities Trading Income of Foreign Investors,* 30 J. TAX'N 98 (1969).

[44] Isenbergh, *The "Trade or Business" of Foreign Taxpayers in the U.S.,* 61 TAXES 972 (1983).

[45] Snell v. Commissioner, 97 F.2d 891, 892 (5th Cir. 1938). (Taxpayer held to be engaged in trade or business of selling land).

Before 1966, the line between securities trading of the type that constitutes a "trade or business" and securities trading not constituting a "trade or business" was drawn on a case by case basis. Decisions considered factors such as the discretionary power given to agents in the United States, and the frequency and volume of trade, resulting in distinctions that appeared obscure and intricate to those not tutored in tax law.[46] The complicated state of the law led Congress in 1966 to enact a special safe harbor for certain foreign traders.[47]

At present, a general safe harbor permits all traders to trade through an independent non-discretionary agent, as long as the trading is not carried on through a United States office. Under a special safe harbor, traders for their own account—as contrasted with brokers—can give discretionary authority to a United States agent or use a United States office, unless the trader is either a dealer or a widely held investment company with its principal office in the United States. Foreigners may benefit from one of the two statutory carve-outs from the concept of United States "trade or business" even if buying and selling is continuous and regular.

The statute[48] provides that a foreigner will not be deemed to be engaged in a trade or business in the United States if:

(i) Trading in stocks or securities through a resident broker, commission agent, custodian, or other independent agent.
(ii) Trading in stocks or securities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident

---

[46] *See* Fernand Adda, 10 T.C. 273 (1948), *aff'd,* 171 F.2d 457 (4th Cir. 1948), *cert. denied,* 336 U.S. 952 (1949) (Egyptian held to be engaged in a U.S. trade or business during 1941 when he authorized his brother, a resident of the U.S., to use discretion in effecting trades in commodities on his behalf). The court stated: "While the petitioner did not have a physical 'office or place of business' in the United States . . . he had what was a more potent means of doing business in the United States, since his brother was authorized to use his own discretion . . . . We hold that [the exemption for transactions effected through a resident broker] is not applicable here, where the alien has an agent in the United States using his own discretion in effecting transactions for the alien's account." *Id.* at 278. *Compare* Fernand Adda, 10 T.C. 1291 (1948) (same Egyptian held not to be engaged in U.S. trade or business during 1943, when his brother did not participate in the trading); Scottish American Investment Co., Ltd., 12 T.C. 49 (1949) (a foreign investment corporation, held not engaged in a U.S. trade or business because decisions as to transactions in securities made directly by the home office in Scotland).

[47] Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 89th Cong., 2d Sess., (approved for taxable years beginning after Dec. 31, 1966). The U.S. also abandoned, in part, the so-called "force of attraction" principle whereby passive investment income was exposed to full U.S. tax by being "attracted" to unrelated separate U.S. business activity. The force of attraction principle was retained for business profits that are not gains from sales of capital assets. *See* I.R.C. § 864(c), and Treas. Reg. § 1.864-4(b).

[48] I.R.C. § 864(b)(2)(A).

> broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. . . .

The first safe harbor applies "only if, at no time during the taxable year, the taxpayer has an office or other fixed place of business in the United States through which or by the direction of which the transactions in stocks or securities, or in commodities, as the case may be, are effected."[49]

The second safe harbor does not apply in the case of a securities dealer.[50] The investor's profit due to the securities' appreciation in value is distinguished from the dealer's mark-up on resale to customers, where securities are sold in the ordinary course of business, like the inventory of other merchants. Nor does the second safe harbor apply to a widely-held corporation whose principal business is securities trading for its own account, if its principal office is in the United States.

Broad use of agents with discretionary power was permitted to encourage foreign investment in the United States. The theme of this safe harbor is a better balance of payments through allaying fears that giving a broker or agent discretionary power to make investment decisions according to his judgment constitutes being engaged in a United States trade or business.

As long as they are not dealers, the following types of persons can trade for their own account (not as brokers) through discretionary agents in the United States, or through an office in the United States, without being deemed to be engaged in a United States trade or business:

1. an individual non-resident alien,
2. a widely-held foreign investment fund whose principal office is outside the United States,
3. a closely-held investment fund (which means five or fewer individuals) regardless of the location of its principal office.

Brokers, dealers and widely-held offshore investment funds with their principal office in the United States must meet the first general safe harbor. To be statutorily certain not to be engaged in a United States trade or business, the trading must be conducted through an independent agent who does not have or regularly exercise discretionary authority to conclude contracts. The taxpayer must have no office or fixed place of business in the United States through which the securities transactions are effected. Only a foreigner trading for his own account (i.e. not as a broker) and not a dealer may give the agent the discretionary power to make judgments and decisions with respect to purchases and sales, hire an employee in the United States to do the trading, or trade himself through an office in the United States.

---

[49] I.R.C. § 864(b)(2)(C).

[50] Treas. Reg. § 1.864-2(c)(2)(iv)(a) defines a dealer as a merchant with an established place of business regularly engaged in buying securities and selling them to customers.

A foreign corporation managed and controlled in the United States is subject to the same restrictions as the dealer unless the company is so closely held (controlled by five or fewer individuals) as to be treated as an aggregate of individuals.[51] Congress apparently felt that if widely held investment companies and dealers could use a discretionary agent, they would have a distinct competitive advantage over their American counterparts.

These exclusions establish what persons are not engaged in a United States trade or business. However, traders outside the safe harbors are not necessarily engaged in a United States trade or business. What might be termed the "common law of trade or business" is left to judges and the Internal Revenue Service to deal with on a case by case basis. In this area it is tempting to apply analogies from other parts of the Internal Revenue Code—such as deductibility of business expenses,[52] bad debts,[53] and capital gains.[54] However, the same words may have different meanings as applied to different sections of the Code,[55] and therefore one should proceed cautiously when reasoning by analogy with reference to the "trade or business" concept in other contexts.

For purposes of these offshore investment fund provisions, the Treasury Regulations generally treat partnerships as entities, rather than as aggregates of individuals.[56] Partnerships may grant discretionary power to a United States agent without being considered engaged in a United States business under rules analogous to those applicable to corporations. They cannot trade through a principal office in the United States, or they must be controlled by five or fewer individuals.

The critical questions of whether an offshore fund has its "principal office" in the United States will be determined by comparing the non-trading activities conducted by a United States office with those conducted by a foreign office. A foreign corporation that maintains a general management office outside the United States will not be considered to have its principal office in the United States if substantial management functions—functions other than its investment and trading activities—are conducted outside the United States.[57] Management functions include: communicating with share-

---

[51] The five or fewer rule comes from reference to the personal holding company provisions. I.R.C. §§ 541 *et seq.*

[52] I.R.C. § 162.

[53] I.R.C. § 166.

[54] I.R.C. § 1221.

[55] *See* AMP v. United States, 492 F. Supp. 27 (M.D. Pa. 1979). (Income characterized as sales proceeds for purposes of determining whether the taxpayer should receive capital gains treatment may be characterized as royalties for purposes of foreign tax credit). *See also* Snow v. Commissioner, 416 U.S. 500 (1974) ("trade or business" as it appears in I.R.C. § 174—experimental expenditures).

[56] Treas. Reg. § 1.864-2(c)(2)(ii).

[57] Treas. Reg. § 1.864-2(c)(2)(iii).

holders and the general public; soliciting sales of its own stock; accepting the subscriptions of new stockholders; maintaining and auditing corporate records; paying dividends, legal and accounting fees, and officers' and directors' salaries; conducting meetings of shareholders and directors; and making redemptions of its own stock.

1. Dealer-Agents

Many foreign banks that act as agents for customers who seek anonymity by buying and selling securities through nominee accounts also trade for their own account, and may also act as securities dealers outside the United States.[58] When trading for its own account, the bank normally must come within the first, general, safe harbor. It must trade through an independent agent without discretionary authority. The bank, even if not a dealer in the transaction in question, acts in a dealer capacity outside the United States. The safe harbor permitting discretionary agents for investors trading for their own account is denied dealers in all transactions, not just those transactions where the trader acts as a dealer. If the bank is engaged in a trade or business, even the dealer profits that arise from trading through an independent agent without discretionary authority would be taxed. These profits would arise from sales of inventory, not capital assets, and thus a residual "force of attraction" will cause these United States source sales to become "effectively connected" with other United States trade or business even if unconnected to its dealer activities.[59] Applicable treaties might, of course, modify the tax treatment of the foreign bank.

The Regulations provide a sensible solution, although neither obvious from a literal reading of the Regulations, nor necessarily warranted by the text of the statute. A foreign bank will not be deemed a dealer as to transactions in which the bank is merely acting as an agent for its customer, as long as it provides a written representation that it is investing the funds of customers and does not have a United States office. The Treasury Regulations provide:[60]

> A foreign person who otherwise may be considered a dealer in stocks or securities under (a) of this subdivision shall not be considered a dealer in stocks or securities for purposes of this subparagraph—
>
> . . .
>
> (2) Solely because of transactions effected in the United States in stocks or securities pursuant to his grant of discretionary authority to

---

[58] Many foreign countries permit banks to be merchant or investment banks as well as commercial banks.

[59] I.R.C. § 864(c)(3) applies a residual force of attraction to U.S. source business profits (as compared to passive investment income), so that dealer gains will be "effectively connected" to the conduct of another U.S. trade or business. *See* Treas. Reg. § 1.864-4(b).

[60] Treas. Reg. § 1.864-2(c)(2)(iv)(b).

> make decisions in effecting those transactions, if he can demonstrate to the satisfaction of the Commissioner that the broker, commission agent, custodian, or other agent through whom the transactions were effected acted pursuant to his written representation that the funds in respect of which such discretion was granted were the funds of a customer who is neither a dealer in stocks or securities, a partnership described in subdivision (ii)(b) of this subparagraph, or a foreign corporation described in subdivision (iii)(b) of this subparagraph.
>
> . . .
>
> This [subparagraph (iv)(b)] shall apply only if the foreign person at no time during the taxable year has an office or other fixed place of business in the United States through which, or by the direction of which, the transactions in stocks or securities are effected.

This Regulation permits banks to use discretionary agents (the American brokers) for their customers without being considered engaged in a United States business merely for that reason. The bank's own trading must still fall within the more general statutory first safe harbor. When the bank wears two hats (dealer and agent for customers), the customer is not penalized because his agent is also a dealer. An American broker with discretionary authority becomes a sub-agent for an undisclosed principal who is permitted to use a broker with discretionary power.

This special solicitude for foreign dealers springs from a concern not to impede the foreign investment that is funnelled through foreign banks. Treasury Decision 6948 (March 1968) noted that "European banks are a source of potentially huge volumes of investment in United States stocks and securities," and that the "Regulations would permit such banks [in a non-dealer capacity] to give discretion [to United States agents] . . . without paying a United States capital gains tax in respect of such transactions."

The administrative largesse for banks is not without problems, both of policy and of draftsmanship. First, foreign investment is encouraged at the cost of both revenue raising and neutrality with respect to domestic taxpayers. Second, to define "dealer" as a function of whether the bank has an office in the United States would lead one to believe that the Regulation is a gloss on the first (general) safe harbor (permitting use of an independent agent) rather than the second safe harbor (trading for one's own account).

Despite problematic draftmanship and policy, the Regulations achieve their purpose. The bank will not be deemed a dealer if it satisfies the conditions set forth in the Regulations, including written representations to the United States broker that the funds are not those of the bank trading for its own account. The bank's own business, therefore, can be done through independent agents without being effectively connected.[61]

---

[61] See Example 2 of Treas. Reg. § 1.864-2(c)(iv)(c).

2. Stock in Non-Publicly Traded Companies

The Foreign Investment in Real Property Tax Act (FIRPTA) creates complications on sale of stock of non-publicly traded domestic corporations. Enacted in 1980, and modified in 1984, the FIRTPA régime operates to impose a tax on sales of stock in domestic corporations with substantial assets in United States real estate.[62] A foreigner's gain on sale of a domestic corporation that is characterized as a "United States real property holding corporation" will be deemed effectively connected to a United States trade or business even if the foreigner does not in fact have a United States trade or business. A "United States real property holding corporation" includes a corporation whose United States real property interests are valued at fifty percent (50%) or more of the market value of all real estate and "trade or business" assets.[63]

Recent amendments to the Code enforce the tax by a withholding obligation of ten percent (10%) of the amount realized.[64] The withholding obligation presumes that a privately held United States corporation is a "United States real property holding corporation." To relieve the buyer of the withholding obligation, a non-publicly traded corporation whose stock is being sold must furnish an affidavit, signed under penalty of perjury, that it is not a United States real property holding company.[65] This requirement of proof that the corporation is not a real property holding company may have untoward consequences for foreign investors. For example, a foreign venture capital fund that sells its shares in a small high-tech company may not be able to obtain the necessary documentation from the company, due to any number of reasons, including tardiness on the part of the management. The seller may be subject to ten percent (10%) withholding even though the privately held company whose shares are sold does not own substantial real estate.[66]

---

[62] I.R.C. § 897.

[63] I.R.C. § 897(c)(2). *See generally*, Park, *Tax Planning for Foreign Investment in American Real Estate*, 1 J. STRATEGY INT'L TAX'N 247 (1985). FIRTPA also provides "look-through" provisions to prevent the use of intricate corporate structuring to avoid "United States real property holding corporation" status. I.R.C. § 897 (c)(5)(A)(i)-(iii); *see also* Temp. Treas. Reg. § 6a.897-1(f)(1982). Corporate reorganization provisions and FIRTPA provide an example of the need for technical virtuosity in implementing policy.

[64] I.R.C. § 1445.

[65] I.R.C. § 1445(b)(3). *See also* Rev. Proc. 85-41 (1985) on procedures for obtaining a certificate to reduce or eliminate FIRTPA withholding.

[66] This point has been made by Kaplan, *Tax Act of 1984: Provisions of Special Interest to Firms Doing Business Internationally*, 1 J. STRATEGY INT'L TAX'N 1, 19 (1984).

3. Treaties

Application of an income tax treaty may present a new wrinkle to alter one or more of the aforementioned rules.[67] Capital gains of a resident of a nation with which the United States has an income tax treaty will generally be subject to tax only in the country of taxpayer's residence, assuming the seller does not have in the United States what the treaties call a "permanent establishment" (or in some cases a "fixed base").[68] The "permanent establishment" concept implies a deeper degree of economic penetration than merely "doing business."[69]

Treaties generally are overridden by the provisions of the Foreign Investment in Real Property Tax Act.[70] Sale of stock in a domestic United States real property holding company will be taxed as if the treaty did not exist. This treaty "override" may not apply to treaties renegotiated since this Act was passed. In a recent Revenue Ruling,[71] the Internal Revenue Service considered the special benefits of the old treaty with Canada, which were extended by the new treaty with Canada. The new treaty entered into force in 1984. These benefits continue to be available, as provided in the new treaty, despite the Foreign Investment in Real Property Tax Act.

II. "Outbound Investment"—The United States Taxpayer

A. *The Foreign Tax Credit*

Although taxable on worldwide income, the United States citizen, resident or domestic corporation may claim foreign income taxes as a credit against his or its United States tax.[72] The amount of the credit is limited, to

---

[67] *See generally,* Osgood, *Interpreting Tax Treaties in Canada, the United States and the United Kingdom,* 17 Cornell Int'l L.J. 255 (1984).

[68] *See* U.S. Model (1981 Draft) Art. 13. The Swiss-U.S. Treaty is unusual in that it provides for taxation by the U.S. only of U.S. source income, as compared to all income attributable to a permanent establishment.

[69] For example, stocks of goods and construction sites do not necessarily constitute a trade or business. A recent Revenue Ruling may have eroded the difference between "trade or business" and permanent establishment. *See* Rev. Rule. 85-60, concerning the business profits of a foreign trust with a non-resident alien beneficiary, where the trust was a member of a U.S. limited partnership. A foreign enterprise will be deemed *not* to have a permanent establishment as to income not effectively connected to a U.S. trade or business. I.R.C. § 894(b). Thus, if a foreign fund can show that its profits are not effectively connected to its U.S. trade or business, it will not matter whether it has a permanent establishment.

[70] *See* Pub. L. No. 96-499, § 1125(c).

[71] Rev. Rul. 85-76.

[72] I.R.C. §§ 901-08. The option of deductibility is provided by I.R.C. § 164. Election of credit is generally advantageous to taxpayer if there is enough foreign source income.

prevent foreign taxes from "spilling over" to shelter United States source income from United States tax. The credit is intended to reduce double tax on foreign source income, not to give an indirect subsidy to foreign countries with rates higher than those applied by the United States. For example, tax may be imposed at sixty percent (60%) in France but fifty percent (50%) in the United States. Without a limit, the extra ten percent (10%) could shield United States income from United States tax. The mechanism for preventing "spillover" involves a calculation based on the ratio of foreign source taxable income to total (worldwide) taxable income.[73] This fraction, applied to United States tax liability, produces a limitation on the credit.[74] Thus the taxpayer may benefit from having more rather than less of his or its income characterized as foreign source.

B. *Source Rules*

The normal source rules include as foreign income dividends and bond interest from foreign corporations and gains from the sale of personal property sold outside the United States.[75] The place of sale is the country where right, title and interest (or in some cases risk of loss, if seller retains "bare legal title") pass to the buyer, as determined by the facts and circumstances of each case.[76] Sale on a foreign stock market or delivery of securities to an exchange agent outside the United States normally renders the place of sale foreign.[77]

Abuse of source rules may occur when, to increase the amount of currently creditable tax, a United States taxpayer artificially augments the amount of income characterized as foreign source.

To reduce manipulation of the place of sale in securities transactions, the source rules for capital gains have been modified. Special rules recharacterize as United States source the gain from sales of capital assets that are

---

[73] I.R.C. § 904(a)

[74] Existing law generally permits a taxpayer to average his foreign taxes from all foreign countries.

[75] I.R.C. § 861 and § 862 and Treas. Reg. § 1.861-7. Sections 861(a)(1)(C) and 861(a)(2)(B) provide that interest and dividends from a foreign corporation with fifty percent (50%) or more of its gross income effectively connected to a U.S. trade or business will be characterized as U.S. source income in the same proportion that such "effectively connected" income bears to the corporation's gross income. Also, § 861(a)(1)(B) and § 861(a)(2)(A) at present exclude from U.S. source income interest and dividends from domestic corporations where less than twenty percent (20%) of the gross income of such corporation is U.S. source.

[76] Treas. Reg. § 1.861-7(c). Source of gain on sale of personal property is determined by the place where the sale is consummated by transfer of right, title and interest or, in some cases, risk of loss. *See* United States v. Balanovski, 236 F.2d. 298 (2d. Cir. 1956).

[77] Rev. Rul. 73-572, 1973-2 C.B. 289; Private Rul. 7308161280A (Aug. 16, 1983).

personal property (rather than realty) when the sales are motivated by tax avoidance.[78] Such gain is treated as United States source when (i) the foreign tax is imposed at a rate of less than ten percent (10%) and (ii) the sale is outside the seller's country of residence.[79] The foreign source income is transubstantiated into United States source income.

The rule is intended to prevent an individual with excess foreign taxes from soaking them up with foreign income from a jurisdiction where no tax is paid. For example, a United States citizen residing in France, with foreign taxes paid at a rate higher than the United States rate, might try to soak up these "excess credits" by selling securities in Zurich. Although there would be no Swiss tax, the sale would otherwise increase the foreign tax credit limitation by increasing the foreign source income. The hope would be as follows: By putting the place of sale into a low tax foreign country, puffing up foreign income like a soufflé, excess foreign tax credits would be applied against foreign source income on which no foreign tax was paid. However, the anti-abuse source rule prevents the American resident in Paris who is selling in Zurich from including the amount of the gain as foreign source for computation of his foreign tax credit limitation.

Another way to abuse source rules so as to eat up excess foreign tax credits would be to purchase foreign financial instruments. Such instruments would throw off foreign source interest, but might be subject to a low rate of foreign tax. The goal of the exercise would be to inflate the numerator of the foreign tax credit limitation fraction without incurring additional foreign tax. This trick is curtailed by applying the credit limitation separately to "investment interest," unrelated to active conduct of a business.[80] The United States tax on the "separate basket" investment interest is not reduced by excess credits spilling over from other income.

Recent reform proposals would extend the separate basket approach to other categories of passive income.[81]

C. *Currency Fluctuations*

If the currency in which the foreign tax is paid fluctuates with respect to the dollar between the date the tax is accrued and the date the tax is paid, the issue arises as to the exchange rate at which the United States dollar equivalent of the foreign tax should be calculated. Cash basis taxpayers use the rate at the date of payment of the tax. Accrual basis taxpayers use the exchange rate in effect on the last day of the taxable year of accrual.[82] For

---

[78] I.R.C. § 904(b)(3)(C) and Treas. Reg. § 1.904(b)-3.

[79] The country of taxpayer's residence is determined with reference to his intentions with regard to the length and nature of his stay. *See* Treas. Reg. § 1.904(b)-3(f), referring to the test of Treas. Reg. § 1.871-2(b).

[80] I.R.C. § 904(d).

[81] *See* H.R. 3838, 99th Cong., 1st Sess., § 601 (1985).

[82] Rev. Rul. 73-491, 1973-2 C.B. 268, issued under I.R.C. § 905.

example, a tax liability of FF100 might accrue to France in 1984 when the rate is FF8 = $1. But the tax may actually be paid in 1985, when the rate is FF10 = $1. For the cash basis taxpayer the tax credit would be $10, even if he elected to take the credit for the 1984 taxable year.[83] An accrual basis taxpayer, however, would obtain a credit of $12.50, calculated at the rate when the liability to pay the tax accrued, and when the income was includible in income in the United States.

Whether the gain from currency fluctuations will be "integrated" into the profit from the sale itself, or considered a separate transaction, is a subject for another symposium on the "integrated" and "separate transactions" approaches to currency fluctuations.[84] For example, fluctuations on bond prices due to exchange rate changes might be deemed interest under an integrated approach.

Foreign exchange gains or losses may arise from the purchase of bonds denominated in foreign currency, when the value of the foreign currency appreciates or depreciates before the amount is repaid. Recent tax reform proposals,[85] which adopt many of the 1980 Treasury "Discussion Draft" proposals,[86] address these issues. The reform proposals deal with timing of recognition of gain or loss, characterization of gain as ordinary or capital, and characterization of its source for foreign tax credit limitation purposes. Generally, a gain or loss on foreign currency-dominated assets (e.g., a bond) will be treated as if the amount of interest income received with respect to that asset were increased or decreased, respectively, by that amount. Thus, the gain or loss would be ordinary, and its source would generally be determined by the residence of the borrower. This rule relating to foreign currency-denominated assets is often referred to as "interest equivalency."

III. Anti-Abuse Régimes

At least five penalty régimes (sometimes referred to as the "pentapus" by Professor Harvey Dale of New York University Law School) may apply to foreign corporations trading in United States securities: (i) the personal holding company provisions,[87] (ii) the foreign personal holding company

---

[83] Such election would be made under I.R.C. § 905.

[84] On tax aspects of currency fluctuations, *see generally* Campbell, *Tax Implications of Gains and Losses*, in FOREIGN EXCHANGE TRADING TECHNIQUES 117 (D. Mandich ed. 1976). *See also* Horst, *Foreign Exchange Gains and Losses: What Are the Issues?*, Oct. 1985 TAXES INT'L.

[85] *See* H.R. 3838, 99th Cong., 1st Sess. (1985), proposing addition of I.R.C. § 988. *See also* House Ways & Means Committee Report, 99th Cong., 1st. Sess. 450-67 (1985), discussing I.R.C. § 1271 and § 1272.

[86] Treasury "Discussion Draft," 45 Fed. Reg. 81, 711 (1980).

[87] I.R.C. §§ 541-547.

provisions,[88] (iii) the Subpart F régime,[89] (iv) the accumulated earnings tax;[90] and (v) the foreign investment company provisions.[91]

The personal holding company régime imposes a penalty tax of fifty percent (50%) on "undistributed personal holding company income," which includes dividends and interest received by a personal holding company. A foreign corporation classified as a personal holding company in general is subject to the personal holding company tax only on United States source income.[92] If all shareholders are non-resident aliens, this penalty tax on United States source dividend and interest income normally will not apply.[93] This penalty tax, enacted more than fifty years ago out of concern for use of closely held corporations to shelter passive investment income, applies only if at least fifty percent (50%) of the equity is owned by five or fewer individuals.

If United States persons control the offshore funds, the "foreign personal holding company" régime—distinct from the "personal holding company" tax—may operate to attribute the foreign fund's profits to its American shareholders. A "personal holding company" does not include a foreign personal holding company,[94] which means that the provisions for the latter prevail over those for the former.

Profits of a foreign corporation controlled by more than five individuals, may still be subject to United States tax under the provisions of "Subpart F" of the Internal Revenue Code, which attributes to "United States shareholders"[95] certain tainted categories of income of a "controlled foreign corporation,"[96] or earnings reinvested in American property such as the debt instruments of affiliated companies.[97] These categories of "tainted income" overlap, but are not co-extensive with, the income subject to tax under the

---

[88] I.R.C. §§ 551-558.

[89] I.R.C. §§ 951-960.

[90] I.R.C. §§ 531-537.

[91] I.R.C. §§ 1246-47.

[92] Treas. Reg. § 1.541-1(b).

[93] I.R.C. § 542 (c)(7). A *domestic* corporation engaged in investment activities in the U.S. and wholly owned by a nonresident alien is *not* within the foreign corporation exception and thus is subject to the personal holding company tax. Rev. Rul. 85-140, 1985-36 I.R.B. 9, interpreting I.R.C. § 542(c)(7).

[94] I.R.C. § 542(c)(5).

[95] U.S. shareholder is a U.S. person owning ten percent (10%) or more of the equity.

[96] A controlled foreign corporation is a foreign corporation more than half of whose voting power is owned by U.S. persons owning at least ten percent (10%) of the voting power. I.R.C. § 957. In Garlock v. Commissioner, 489 F.2d. 197 (2d Cir. 1973), *cert. denied,* 417 U.S. 911 (1974), it was held that *de facto* control is what counts, permitting the Internal Revenue Service to disregard mere "formal" stock ownership. See Treas. Reg. § 1.957-1(b)(2).

[97] I.R.C. § 956.

"foreign personal holding company" régime. Income that would otherwise be included under both the foreign personal holding company provisions and Subpart F will be taxable under Subpart F.[98]

The provisions of the Internal Revenue Code relative to foreign investment companies (entities primarily engaged in the business of investing in securities and whose voting power is at least half owned by United States persons) tax gain on sales or redemptions of stock of a foreign investment company at "ordinary" income rates rather than the preferential capital gain rates.[99]

The first four anti-abuse régimes may be avoided by limiting ownership of the offshore fund to non-resident aliens. This is not true of the accumulated earnings tax, which applies to any corporation, domestic or foreign, that is formed or availed of to avoid the individual income tax on its shareholders.[100] Tax on income accumulated beyond the "reasonable needs of the business" is imposed at rates of 27 1/2% on amounts up to $100,000, and 38 1/2% on accumulations in excess thereof. The tax does not apply to personal holding companies or foreign personal holding companies, but is imposed on United States source income if any of the shareholders are subject to United States tax with respect to distributions by the corporations, even if the shareholders are non-resident alien individuals. The 1984 amendments to the accumulated earnings tax relating to source of income force remittance of investment income on a current basis in order to avoid the accumulated earnings tax.[101]

CONCLUSION

The geographically mobile nature of the international securities market and the need for some inter-nation allocation of taxing competence have shaped American taxation of transborder securities transactions to reflect competing concerns for equity and the integrity of the tax system, on the one hand, and attracting foreign investment, on the other. To attract foreign capital, special provisions provide non-resident aliens a reasonable degree of certainty that they will not be taxed on capital gains (at least if not engaged in a trade or business within the United States) and that they may maintain anonymity in their portfolio investments. The law grapples with the national interest in applying a special tax régime to gain from real estate dispositions disguised as sale of corporate stock.

With regard to our domestic taxpayers, the accent is on preventing evasion and reducing manipulation of the foreign tax credit mechanism, in-

---

[98] I.R.C. § 951(d).

[99] I.R.C. § 1246.

[100] I.R.C. § 532 and Treas. Reg. § 532-1(a).

[101] I.R.C. § 535(d). *See* Klein, *A New Look at Offshore Investment Companies After the 1984 Tax Reform Act*, 1 J. STRATEGY INT'L TAX'N 453 (1985).

tended to alleviate double taxation but not to subsidize foreign tax systems with rates higher than our own. Improper use of the foreign tax credit by Americans trading in foreign securities has led Congress to provide special source rules to reduce manipulation of the place of sale. Moreover, to insure the integrity of the tax system, anti-abuse régimes tax profits of foreign companies controlled by Americans in a more rigorous way than profits of companies controlled by foreign investors whose capital is being courted.

The result of these competing policies is a patchwork that illustrates the interplay not only of rival policy themes, but of the technical aspects of enforcement of the various policies.