Rationalizing Inbound Taxation of Passive Portfolio Investments
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The current system of taxation of U.S.-source income received by foreign persons does not always operate in a sensible fashion when applied to passive investors whose equity interest in an enterprise is relatively small. In particular, the imposition of gross-basis tax on types of income for which there are significant costs can result in a level of tax which is confiscatory when measured by reference to economic income. In addition, the rule which subjects any investor in an entity which is treated as a partnership to full net-basis taxation does not seem warranted for small passive investors.

The authors explore some of these problems and suggest some approaches to improving the taxation of these types of investors.

I. Introduction

The subject of this article is the tax regime applicable to non-U.S. persons that receive passive portfolio-type income from U.S.-connected investments. In general, the set of rules that comprise this regime are the same rules applicable to passive nonportfolio investments, although there are some special modifications in the portfolio investment context. It is the authors' belief that application of the same rules in the context of passive portfolio investments as applied in other contexts is not necessarily good tax policy, and that the existing rules, as applied to passive portfolio investments, do not always produce sound results. This article identifies some of the problems that exist under the current system (specifically as applied to passive portfolio investments) and sets forth proposals to alleviate those problems.

Before addressing specific issues with the application of the existing regime to passive portfolio income, a few words are in order concerning a threshold issue of tax policy. The existing regime is a "source-based" tax system; that is, it imposes a tax on persons who receive income which derives from the United States, even if they are not U.S. citizens or residents and have no connection to the United States other than receiving that income. This is consistent with the tax system used by many countries, and is based primarily on the notion that someone who receives income from U.S. sources benefits from the physical, legal or financial infrastructure in the United States, and hence should bear a portion of the cost of maintaining that infrastructure. However, there is no inherent reason why the United States — or any other country — needs to adopt a source-based system, and...

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some commentators have argued in favor of eliminating (or at least significantly limiting) source-based taxation in favor of a “residence-based” system that looks to the connection the taxpayer (rather than the income) has with the jurisdiction as a basis for taxation.2

A detailed discussion of source- versus residence-based taxation is beyond the scope of this article. Rather, this article addresses some approaches for improving the way the current system operates, assuming that the United States is not willing to cede taxing jurisdiction on passive portfolio income entirely to the jurisdiction of residence.

In addition, U.S. taxation of income and gain from nonportfolio investments of foreign persons raises differ-

2Those commentators generally assert several reasons why residence-based taxation of passive income is a fairer and more efficient system to collect taxes on an international basis. In particular, residence-based taxation satisfies the “ability to pay” principle, since taxation in the residence jurisdiction can more easily take into account the net accession to wealth of a taxpayer determined on a worldwide basis. These advocates also point to the widespread use of various strategies and financial products to avoid source-based tax on portfolio investments, as well as the limited amount of tax collected relative to the administrative and compliance burdens associated with the tax. They also point to the mobility of capital to suggest that taxation of this type of income may be counterproductive and the cost of the tax will generally be economically borne by the domestic payor rather than the payee. It is also argued that elimination of source-based taxation of passive portfolio income of foreign persons would represent a significant simplification of the overall international tax regime. See, e.g., Reuven S. Avi-Yonah, “The Structure of International Taxation: A Proposal for Simplification,” 74 Tex. L. Rev. 1301 (1996); Hugh J. Ault and David F. Bradford, “Taxing International Income: An Analysis of the U.S. System and Its Economic Premises,” NBER Working Paper No. 3056 (August 1989); Michael J. Graetz, “Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies,” The David R. Tillinghast Lecture, NYU School of Law (Oct. 26, 2000) in 54 Tax L. Rev. 261 (2001); Robert A. Green, “The Future of Source-Based Taxation of the Income of Multinational Enterprises,” 79 Cornell L. Rev. 18 (1993); Treasury Dep’t, Blueprints for Basic Tax Reform 99 (1977).


3A 30 percent gross tax is also imposed on limited types of gains, including (i) gains from sales subject to section 631, which include gains from sales of timber, coal, or iron ore when the seller retains an economic interest in the property, (ii) gains from the sale or exchange of intangible property where the sale price is contingent on use, productivity, or disposition of the subject property, and (iii) certain payments on, or other amounts from the sale or retirement of, original issue discount obligations. See reg. section 1.1441-2(b).

4Although the gross tax on fixed, determinable, annual, or periodic (FDAP) income is generally referred to as a withholding tax, it actually represents a substantive income tax liability on the income of the recipient that is collected through a mechanism involving withholding at source. See sections 871(a) and 881 (substantive imposition of tax); sections 1441 and 1442 (withholding mechanism for tax collection). Any withholding is effectively credited against the recipient’s income tax liability, and the recipient is relieved of an obligation to file a U.S. tax return for FDAP income subject to tax, provided that the full amount of the tax has been withheld at source and remitted to the IRS. Reg. section 1.6012-1(b)(2)(i) and (g)(2)(i). However, a recipient remains fully liable for the tax and U.S. tax filing requirements in the event the full amount of the tax liability has not been satisfied through withholding at source.

5See Avi-Yonah, supra note 2, at 1332-1333.

ent policy concerns, and is not addressed in this article. In particular, the tax rules applicable in the non-portfolio investment context are essential for purposes of preventing affiliated persons from employing financial arrangements (including transfer pricing and other mechanisms) that seriously erode the U.S. business tax base.3

II. Overview of the Regime

A. Gross-Basis Taxation

The centerpiece of the tax regime applicable to foreign passive portfolio investors is a 30 percent U.S. federal withholding tax4 on the gross amount of U.S.-source “fixed or determinable annual or periodic” income (so-called FDAP income).5 Gross-basis taxation of passive-type income reflects the assumption that in general, there are likely to be few or no expenses incurred in the production of such income. It also eliminates the additional administrative and enforcement burdens that would arise if foreigners that received such income were required to file U.S. tax returns setting forth applicable expenses.

Several aspects of the definition of FDAP income are significant. First, although the literal meaning of the term would seem to denote a limited class of payments payable on a regular or periodic basis, the regs clarify that the term encompasses effectively all gross income other than capital gains (as well as a narrow class of insurance premiums paid to a foreign insurer), regardless of whether payment of the item is made in a series of repeated payments or in a single lump sum.6 Second, although some early authorities suggested that FDAP income should be limited to types of income that are not likely to have significant expenses associated with producing the income,7 the broad definition reflected in this

Footnote continued on next page.
current regulation includes no such limitation. This is extremely significant. The imposition of gross-basis taxation on types of income with significant associated expenses is inconsistent with the fundamental assumption underlying the system of gross-basis taxation, and, as discussed below, can often result in a confiscatory level of tax.

Certain types of income are specifically exempted from the gross-basis tax regime. The most important of these (from an economic perspective) are (i) “portfolio interest” (generally defined as non-contingent interest received by a foreign taxpayer (other than a bank) that does not own a 10 percent or more (measured by voting power) equity interest in the payor) and (ii) most “gains derived from the sale of property.” Interest on bank deposits and short-term original issue discount are also exempt. In addition, income derived from most types of derivative contracts is also effectively exempt from U.S. taxation (although these rules — or at least their application in what is perceived as abusive transactions — are under attack, particularly where a derivative income (and sometimes even a loss) is derived therefrom. The intent was to include only such kinds of gross income as have a very high content, so to speak, of net income. See also Rev. Rul. 80-222, 1980-2 C.B. 211.

Under the broad definition of FDAP, various types of U.S.-source income not specifically listed in the regulations have been held by the IRS or the courts to constitute FDAP including alimony, gain on surrender of a life insurance policy, gambling winnings, horse race winnings, and compensation for a non-compete agreement. See, e.g., Hawkins v. Commissioner, 49 T.C. 689 (1968) (alimony); Rev. Rul. 64-51, 1964-1 C.B. 322 (life insurance policy); Barba v. United States, 2 Cl. Ct. 674 (1983) (gambling winnings; no deduction or offset for gambling losses) and Rev. Rul. 58-479, 1958-2 C.B. 60 (commissions, prizes, gambling winnings), but see section 871(j) (exempting proceeds from blackjack, baccarat, craps, roulette, or big-6 wheel from withholding tax); Rev. Rul. 85-4, 1985-1 C.B. 294 (horse racing; but see section 872(b)(5) (exempting from withholding tax, any income from a legal wagering transaction initiated outside the United States in a parimutuel pool with respect to a live horse race or dog race in the United States)); TAM 199947031, Doc 1999-37301, 1999 TNT 228-10 (compensation for a non-compete agreement).

Foreign investors may avoid patently unfair results in connection with certain passive U.S. real property-related investments by electing to be subject to net taxation for U.S.-source rents received in connection with those investments (i.e., to obtain the benefit of depreciation, interest expense and other deductions appropriately associated with such investments). However, the election is narrow and inappropriately requires foreign corporations to become subject to branch profits taxation on both income and gain from those U.S. passive real property-related investments.

is effectively a substitute for ownership of an underlying asset the income from which would be subject to tax.

The broad exceptions for gains and most types of interest mean that the key economic component of the gross-basis tax on foreign passive portfolio investors is the tax on U.S.-source portfolio dividend income. There has been significant recent focus on the prospects for a specific exemption from tax for portfolio dividends, along the lines of the current exemption for portfolio interest. The case for this exemption has strengthened significantly with the enactment, in 2003, of a 15 percent maximum rate on qualified dividend income of U.S. taxpayers.

The broad definition of FDAP means that the tax is also applicable to a plethora of other important, albeit less economically significant, types of cross-border financial payments such as rents, royalties, proceeds from annuities and insurance policies, structured settlements, lotteries, and other types of fixed or variable income flows. As discussed above, these other types of cross-border income flows are growing in importance as international capital markets expand beyond traditional debt and equity securities, and begin to encompass many types of assets backed by U.S.-source cash flows. A significant expansion in the type of assets that are subject to securitization transactions has reinforced this trend by making a wide variety of U.S.-source cash flows available to foreign investors in the form of equity interests in securitization vehicles. In fact, secondary markets with international participation have emerged for such diverse types of financial assets as real property, rental payments, royalty streams, payouts on various types of insurance policies, structured settlements payouts, and deferred lottery payments.

The U.S. system of gross-basis taxation is not unique; most other nations impose similar types of gross-basis tax on at least some types of domestic source portfolio investment income of foreign persons. Consistent with international norms, the U.S. gross tax may be reduced or eliminated on certain types of income under the terms of an applicable U.S. tax treaty. However, modern tax treaties and domestic law incorporate a variety of anti-abuse rules designed to limit the ability of foreign investors to reduce or eliminate gross withholding tax through the inappropriate use of tax treaties. In addition, narrow rules exist to prevent these investors from...
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avoiding the gross tax by using certain types of derivative arrangements effectively to change the source of U.S.-source FDAP income.

**B. Net-Basis Taxation**

Another key element of the overall regime imposes net income taxation on income that is effectively connected with the conduct of a trade or business in the United States. Application of these rules requires a two-step inquiry. First, it is necessary to determine whether a foreign taxpayer is engaged in a trade or business in the United States. If so, the inquiry becomes whether particular items of income are effectively connected with that trade or business. Once it has been determined that a foreign taxpayer is engaged in a trade or business, generally all U.S.-source income that is neither FDAP nor capital gains is considered effectively connected. This principle is generally referred to as the "residual force of attraction" principle.

In the context of a passive portfolio investor, the most significant point about this regime is that any foreign person who is a partner in a partnership engaged in a U.S. trade or business is treated as so engaged. Thus, a person who is a partner in a partnership engaged in a trade or business in the United States. If so, the inquiry becomes whether particular items of income are effectively connected with that trade or business. Once it has been determined that a foreign taxpayer is engaged in a trade or business, generally all U.S.-source income that is neither FDAP nor capital gains is considered effectively connected. This principle is generally referred to as the "residual force of attraction" principle.

In limited circumstances, a taxpayer who was formerly engaged in a U.S. trade or business but is no longer so engaged can be subject to net-basis taxation on certain income. See section 864(c)(3). Whether U.S.-source FDAP income or capital gains are effectively connected is determined under section 864(c)(2) and reg. section 1.864-3. Also, certain limited categories of foreign-source income may, in some circumstances, be treated as effectively connected. See section 864(c)(4).

The IRS takes the position, in general, that any gain on disposition of an interest in such a partnership is effectively connected (Rev. Rul. 91-32, 1991-1 C.B. 107), although the statutory basis for this conclusion has been questioned. This position is quite controversial. See William W. Bell & David B. Shoemaker, "Revenue Ruling 91-32: Right Result For the Wrong Reasons," 9 J. Partnership Tax’n 80 (1992); Edwin J. Reavey & Richard M. Elliott, "Sales of U.S. Partnership Interests by Foreign Partners: New Rules After Rev. Rul. 91-32?" 91 TNI 50-27 (Dec. 1991); Kimberly S. Blanchard, "Rev. Rul. 91-32: Extra-statutory Attribution of Partnership Activities to Partners," Tax (Footnote continued in next column.)

There is a hybrid collection mechanism for net-basis tax on income from partnerships. A partnership is required to withhold, at the highest marginal tax rate for each type of taxpayer, on each foreign partner's share of effectively connected income. This generally applies whether or not income is distributed; however, in the case of publicly traded partnerships, withholding is only required on distributions. Unlike gross-basis withholding, however, there is no expectation that the amount withheld will match the taxpayer's substantive tax liability, and, even if it does, the taxpayer is not relieved of the obligation to file returns.

In order to avoid becoming subject to these rules, foreign investors in partnerships with U.S. business activities frequently hold their partnership interests through a "blocker" corporation, so that the corporation, rather than the investor itself, is treated as engaged in a U.S. trade or business. However, this is somewhat cumbersome, and as discussed below, frequently results in two levels of U.S. tax.

**C. General Observations**

In general, the overall U.S. tax regime applicable to foreign portfolio investors is taxpayer-favorable and reflects, in part, an explicit goal of attracting foreign portfolio investment. It also reflects the administrative difficulty of taxing certain types of U.S. connected income, such as gains. The regime effectively exempts from tax passive gains from income, such as gains. The regime effectively exempts from tax passive gains from the sale of personal property, other than gain from certain partnership and real estate-related investments, (which are treated like active income subject to tax at applicable net income tax rates). This exemption from tax for gains, together with

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**Notes**

1. See reg. sections 1.861-2(a)(7), -3(a)(6); 1.864-5(b)(2)(ii); 1.871-7(b)(2); and 1.881-2(b)(2).

2. Even for taxpayers that are not otherwise engaged in a U.S. trade or business, net-basis taxation applies to gains from the sale of U.S. real estate (or stock of corporations whose assets consist primarily of real estate) under the Foreign Investment in Real Property Tax Act. See section 897. These rules are beyond the scope of this article.

3. In limited circumstances, a taxpayer who was formerly engaged in a U.S. trade or business but is no longer so engaged can be subject to net-basis taxation on certain income. See section 864(c)(3). Whether U.S.-source FDAP income or capital gains are effectively connected is determined under section 864(c)(2) and reg. section 1.864-3. Also, certain limited categories of foreign-source income may, in some circumstances, be treated as effectively connected. See section 864(c)(4).

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the rules that exempt most types of interest, are the most taxpayer favorable aspects of the regime. However, significant types of passive portfolio income remain subject to tax, including portfolio dividends and periodic income from other types of portfolio investments, as well as gains from portfolio interests in U.S. real property holding companies and interests in passive real estate partnerships. Income and gains from portfolio interests in operating partnerships (including publicly traded partnerships) also remain subject to tax.

III. Situations Leading to Inappropriate Taxation
A. Gross Tax on Positions With High Expenses

1. General. A major problem in the operation of the gross withholding tax is that because the gross income tax base fails to take into account those expenses and losses closely or directly associated with an investment, it often serves as an extremely poor measure of economic income related to that investment. The fact that the gross tax rate of 30 percent has historically been lower than the highest marginal U.S. net income tax rates has had the effect of mitigating the economic distortions caused by not taking into account associated expenses and deductions. However, over time, the maximum rate of regular tax has been reduced, while the 30 percent rate of gross-basis taxation has remained the same, with the result that the current discount between the highest marginal net tax rate and the gross withholding rate is small on an historic basis. In fact, with the maximum rate of tax on qualified dividends received by U.S. individual taxpayers at 15 percent, there is actually a negative spread in the case of dividends. With the reduction in regular tax rates over time, therefore, the distortive effect of not allowing expense deductions has increased.

The distortion is further exacerbated for types of passive portfolio investments where recovery of expenses (and other costs which, under a net-basis regime, would be deductible) represent a significant portion of the gross income received from an investment. In this connection, three general types of investments are particularly troublesome. Significantly, in the modern business environment, those types of investments have become more prevalent than they once were.

The first type of investment that exacerbates the distortion is any leveraged purchase of a financial instrument that generates FDAP. Because the cost of carrying the leverage (that is, the interest) is not deductible to a foreign taxpayer, the effective tax rate on economic income is far higher than the nominal 30 percent, and it is not difficult for that effective tax rate to exceed 100 percent.

A similar and sometimes more serious problem arises in connection with income flows from passive portfolio investments derived from wasting assets. Examples of this are depreciable real property, various forms of intellectual property (including patents and term interests in cash flows from the use of copyrights and trademarks), structured settlement payments, and deferred lottery payouts.

In the authors’ experience, investments of those types have become increasingly prevalent as international capital markets have expanded, and as the number and type of asset securitizations have increased. International markets have emerged for nontraditional types of investment assets such as investments in royalty streams and structured settlement payments. For example, the authors have observed the formation of several large pooled investment vehicles to acquire the right to streams of royalty payments that are determined based on the exploitation of pharmaceutical patents and other types of intellectual property (including copyrights) in the United States. A significant secondary market has also developed for unusual types of cash flow investments, including structured settlement payments from settlements of lawsuits and deferred payments to lottery winners. The significant feature of all of these types of investments is that, economically, a portion of the amount received by an investor represents a return of capital. However, in a world of gross-basis taxation, no allowance is made for this.

For example, consider a foreign taxpayer who purchases a stream of structured settlement payments for $1 million. Under the terms of the settlement, he has the right to receive $176,984 per year for 10 years. Thus, over the life of the deal, he will receive a total of $1,769,840, of which, economically, $1 million represents a return of capital and $769,840 represents a 12 percent return on investment. However, if such an arrangement is taxed under the gross-basis regime, unless it is characterized as a debt instrument, the entire $1,769,840 will be subject to tax even though the economic profit is only $769,840.
From the perspective of the taxpayer, such an arrangement is very similar to a debt instrument, and a respectable argument can be made that it should be so treated. If it were, even putting aside the fact that portfolio interest is exempt from withholding tax, the amount subject to tax would be limited to the economic profit. It seems odd that, in order to achieve this economically correct result, a taxpayer should have to argue for characterizing an arrangement in a way that is not consistent with its form.32

A third type of transaction in which the distortion caused by gross-basis taxation can be particularly acute is a hedging or arbitrage transaction. Generally, this involves a taxpayer acquiring a “long” position in one asset, and taking a “short” position in another asset, the value of which is expected to be correlated, to some extent, to the value of the first asset. A taxpayer engaging in these sorts of transactions does not make his money as a return on capital; indeed, the net investment may be quite small. Such a taxpayer also does not make money by correctly predicting which way the market moves. The key to strategies of this type lies in identifying market inefficiencies in the pricing of the two positions. This allows the investor to buy cheap and sell dear, based on the relative prices of the two positions at the time of their acquisition. If the assumptions as to the degree of correlation between the values of the two positions are correct, the profit should economically be locked in at that time, and should be largely unaffected by whether the values thereafter move up or down.

From the perspective of gross-basis taxation, such an investment is highly problematic. Economically, the loss on one side represents a cost of earning the profit on the other side, and the investor’s net economic profit may be only a tiny fraction of the gross profit on the “winning” side. Thus, to the extent that the income on the “winning” side is in the form of FDAP income, gross-basis taxation is likely to be highly distortive, and can easily become confiscatory.

We have identified three types of transactions in which the distortion caused by a gross-basis transaction is likely to be particularly troublesome. The distortion can get even worse where an investment combines more than one of these features. For example, a foreign taxpayer who makes a leveraged purchase of a wasting financial asset will, if income from this asset is subject to gross-basis taxation, have to pay tax not only on economic profit, but also on the amount that represents a return of capital, as well as on the amount he doesn’t get to keep because he has to pay it to the lender as interest.

2. Techniques for avoiding the imposition of a punitive level of gross taxation. In light of the potentially confiscatory level of taxation that could flow from gross-basis taxation on income from some types of transactions, there is a strong incentive to use structures that reduce the tax burden. One approach is to take advantage of treaty relationships. For example, it may be possible to reduce the rate of withholding tax on certain types of income by routing the income through an intermediary corporation organized in one of the few remaining jurisdictions with which the United States has a tax treaty that does not contain a “limitation on benefits” clause. Alternatively, sometimes an overall reduction in taxes can be achieved by using a chain of intermediate entities, taking advantage of the treaty relationships between the countries, as well as peculiarities of internal tax law that may differ from country to country.

The ability to use tax treaties to minimize U.S. withholding tax is not unlimited. In particular, care must be taken to avoid running afoul of the “anti-conduit” regulations.34 However, many transactions can be structured around these rules.

Nonetheless, treaty planning is sometimes cumbersome and, invariably, some portion of the U.S. tax that is saved is instead paid to another jurisdiction (or to advisors in that other jurisdiction).

Another technique for reducing the burden of gross-basis taxation is the use of derivative contracts. In general, income received on a “notional principal contract” is sourced by the residence of the taxpayer.35 Therefore, if a foreign taxpayer, instead of holding an asset directly, holds it synthetically through the use of a derivative that qualifies as a notional principal contract, income received on the derivative would be foreign-source, and hence not subject to gross-basis taxation. In recent years, this technique has been used aggressively to avoid dividend withholding, and it has been the subject of intense scrutiny. Most recently, on September 11, 2008, the Senate Permanent Subcommittee on Investigations, a subcommittee of the Committee on Homeland Security and Governmental Affairs, held a hearing on the use of those techniques. A report released in advance of the hearing concluded that some taxpayers were using derivative contracts to avoid dividend withholding in transactions that the report described as abusive, and recommended action on the legislative, regulatory and enforcement fronts to combat such perceived abuses.36 As discussed in this article however, there are some fundamental problems in the gross-basis taxation regime, and simply closing a perceived “loophole” without addressing those more fundamental issues does not seem appropriate. If

32Interestingly, a U.S. taxpayer holding an identical instrument would prefer that it not be characterized as debt. A nondebt intangible asset with a fixed life would generally be amortized over that life on a straight-line basis (see, e.g., section 167). On the other hand, if it were treated as debt, income inclusions would be calculated using the constant-yield method (see, e.g., section 1272), which would effectively back-load basis recovery.

33The term “loss” in this context is not meant to imply a loss realized on disposition; rather, it refers to the overall economic loss on one side of the overall position. Thus, it may include such out-of-pocket expenses as dividend-equivalent payments on the short position.

34See reg. section 1.881-3.

35See reg. section 1.863-7(b).

36Dividend Report, supra note 16.
Another possible approach to avoiding punitive levels of gross-basis taxation is to invest through a special conduit vehicle, such as a regulated investment company or a real estate investment trust. However, this technique has significant limitations since RICs and REITs have strict limitations on ownership, investments, and operations. Accordingly, RICs and REITs can only be used in limited circumstances and cannot be used to achieve net-basis taxation for investments in various asset classes (such as realty, insurance, settlements, and lottery winnings) or for certain leveraged and arbitrage-based investment strategies.41

The planning solutions available to deal with the inability of a gross tax system to deal with income from leveraged, hedged, and wasting assets are inadequate, and the planning option of requiring foreign investors to incur two levels of U.S. tax on income from passive portfolio investments is neither practical nor fair. From a fairness and neutrality point of view, it makes little sense to require foreign persons to become subject to two levels of U.S. taxation on passive portfolio income to remedy issues associated with imposition of the single level gross basis taxation of such income.

B. Investments in Operating Partnerships

The net-basis tax regime also suffers from serious flaws as applied to passive portfolio investors. Specifically, if a partnership is sufficiently active so as to be treated as engaged in a U.S. trade or business, a foreign partner becomes subject to the net-basis regime even if that partner is a totally passive portfolio investor.42 Moreover, under the IRS’s view, this almost always results in taxing the investor not only on operating income of the partnership itself, but also on gain from the sale of the partnership interest.43 This is significantly different than the rule applicable to corporations, where a sale of stock by a foreign person generally is not subject to U.S. tax.

Presumably the theory underlying this concept is the assumption that there should be at least a single level of U.S. tax on all active business income generated in the United States and that this conclusion is consistent with international norms.44 However, this conclusion is not

41Before 2004, using a RIC had an additional disadvantage in that interest and short-term capital gains were effectively transformed into dividend income subject to 30 percent withholding tax (even though they would have been free of withholding tax if they had been earned directly by the taxpayer). Under current law interest income and short-term capital gains of RICs retain the character on distribution from the vehicle. See section 871(k). However, this rule will sunset on December 31, 2009, unless extended by Congress. See section 206, H.R. Rep. No. 1424, 110th Cong., 2d Sess. (2008).

42See supra note 24 and accompanying text.

43See supra note 25 and accompanying text.

44In the area of operating income, since there is no entity-level tax the income would escape U.S. tax entirely if it were not taxed to the foreign partner. In the case of gain on sale of a partnership interest, if an election is made under sections 743 and 754 the buyer will receive a basic step-up in his share of the partnership’s assets to reflect the price paid for the partnership interest. This will result in less gain on ultimate sale and, to the

(Footnote continued on next page.)
in inevitable, especially on income generated from passive portfolio investments in U.S. businesses. As noted above,45 full residence-based taxation of income and gains from passive portfolio investments in active U.S. businesses is a realistic alternative. In fact, the United States has already ceded taxation over most income earned in connection with active U.S. businesses involving the trading of stocks, securities and commodities. Furthermore, the exemption from tax on portfolio interest income means that the United States has ceded full taxing jurisdiction of business income that is paid to foreign persons in the form of portfolio interest, which is not subject to any taxation in the United States.

Even if one accepts the notion that a single level of tax should be paid on all income of a U.S. business, the current system goes far beyond what is needed to ensure that result. As a result of the residual force of attraction principle, U.S.-source income that is totally unrelated to the partnership’s business can become subject to tax. Moreover, the partner is required to file U.S. tax returns. While this may seem like a mere administrative inconvenience, its practical implications are quite important. For many foreign investors, filing U.S. tax returns — or having any contact at all with U.S. taxing authorities — is simply unacceptable.

As a practical matter, most foreign persons investing in operating partnerships do so through a “blocker” corporation. This, however, generally results in not one, but two levels of U.S. tax, even if the actual foreign investor is an individual.46

The plethora of investment vehicles and financial instruments available today mean that it is more likely than ever that an investment partnership may engage in instruments available today mean that it is more likely than ever that an investment partnership may engage in activities that may fall outside the “trading for one’s own account” safe harbor,47 and that may therefore constitute a U.S. trade or business. Thus, in today’s environment, the overbreadth of the net-basis taxation regime is troubling.

The following is a description of several proposals for change to the tax regime applicable to the taxation of passive portfolio income of non-U.S. persons that seem worthy of consideration. The first is a proposed change in the rate of tax on U.S.-source FDAP (and, in particular, portfolio dividends) to take into account changes in the broader U.S. income tax system and the global economy. The second category involves introduction of a new net income tax election designed to permit avoidance of patent unfairly and inappropriate results that can result from gross taxation. Finally, we set forth some proposals to overhaul the taxation of passive portfolio investments in partnerships operating U.S. businesses.

IV. Proposed Changes to the Regime

A. Reduction of Gross Tax Rate

1. General reduction in 30 percent statutory rate. As discussed above, the current 30 percent U.S. gross withholding tax rate is extraordinarily high relative to the maximum tax rate imposed on domestic taxpayers and others subject to net-basis taxation. This is inconsistent with the theory that gross-basis taxation represents a “rough justice” substitute for net-basis taxation, without the administrative burden that would ensue if foreign portfolio investors had to substantiate actual expenses.

At least one commentator has suggested that the high rate is based on an implicit recognition that the tax will not often be paid, and is likely maintained purely as a bargaining chip in tax treaty negotiations.48 The argument that a high rate is important in the context of tax treaty negotiations seems weak, at least regarding rates applicable to portfolio type income. The U.S. has successfully negotiated tax treaties that provide for zero taxation of interest even though the U.S. exempts portfolio interest.49 Other countries successfully negotiate tax treaties with favorable rates for dividends even though they impose no tax on dividends paid to foreign investors pursuant to domestic law.50

45 See supra note 2.
46 If a foreign blocker is used, it will be subject to regular corporate tax as well as branch profits tax. If a U.S. corporation is used, it will be subject to regular corporate tax, and the shareholder will be subject to withholding tax on any dividends.
47 A taxpayer that attempts to avoid a second level of tax by using a U.S. blocker and making no distributions currently may run into the accumulated earnings or personal holding company tax, and will also incur regular corporate-level tax on income from reinvested funds, even if that reinvestment income is of a type (for example, interest) that would have escaped U.S. taxation entirely if a blocker corporation had not been used.
48 See Avi-Yonah, supra note 2, at 1374.
One proposal, therefore, would be to reduce the rate of gross-basis tax so that its relationship to the maximum net-basis tax rate is closer to historical rates.

2. **Elimination or reduction in tax rate for portfolio dividends.** It seems especially difficult to rationalize the current system of gross-basis taxation as applied to portfolio dividend income. As a result of the reduction of the maximum tax rate (for domestic individual taxpayers) on qualified dividend income to 15 percent in 2003, we have a somewhat bizarre situation in which foreign persons pay twice as much tax as domestic taxpayers pay on the same type of income. A second reason why the 30 percent tax on dividend income is difficult to justify is the existence of the portfolio interest exception. Portfolio interest income earned by a foreign owner of most types of debt issued by a U.S. corporation will not be subject to any tax in the United States, while dividend income earned by a foreign owner of an equity interest in a U.S. corporation will effectively bear two levels of taxation in the United States (a tax at the corporate level and a second level withholding tax when paid to the foreign investor). In contrast, the discrepancy between income on debt and income on equity held by U.S. taxable investors is only a single level of tax (that is, a single level of tax on interest income compared to two levels of taxation on dividend income).

The U.S. tax system provides an obvious economic bias in favor of debt investments over equity investment in U.S. corporations. The inherent disparity in taxation of portfolio interest and portfolio dividends exacerbates this disparity and creates a significant incremental bias in favor of debt financing of U.S. corporations by creating an incremental incentive for foreign persons to hold debt rather than equity issued by U.S. corporations.

Strong arguments, therefore, can be made that the withholding tax on dividends should either be eliminated or that the rate should be significantly reduced.

**B. Election to Avoid Certain Inappropriate Results**

As discussed above, imposition of gross-basis tax on income from portfolio investments with a high expense/cost component may lead to unfair and punitive taxation that can serve as a trap for the uninformed or an impediment to passive portfolio investment in the United States. One solution to this problem would be to permit foreign taxpayers to elect to be taxed on a net basis, even for transactions that would otherwise give rise to FDAP income.

Precedent for such an election exists under sections 871(d) and 882(d), which allow just such an election for foreign investors in passive real estate investments.\(^{51}\) However, one important change should be made to the system that exists under sections 871(d) and 882(d). Specifically, corporations that elect into the regime (including foreign pooled investment vehicles treated as corporations for U.S. tax purposes) should not be subject to branch profits taxation. It is unclear why corporations that make the section 882(d) election are subject to branch profits taxation on amounts other than gain from the sale of the property.\(^{52}\) The branch profits tax ostensibly was designed to create rough parity between taxation of active U.S. subsidiaries and active U.S. branch operations of foreign corporations,\(^{53}\) and therefore imposes a second level of taxation on the foreign corporation on an amount of profits deemed repatriated from a branch (somewhat equivalent to the withholding tax on dividends remitted from a U.S. subsidiary).\(^{54}\) The policy of collecting a second level of U.S. tax does not seem warranted in the context of passive investments, especially passive portfolio investments.\(^{55}\) The U.S. tax system provides various special rules, such as the RIC, REIT, and publicly traded partnership rules, designed to exempt passive-type investment income of domestic taxpayers from multiple levels of taxation. A net income election available to foreign corporations that would permit avoidance of the branch profits tax would be consistent with the tax treatment provided to foreign corporations that make passive portfolio investments through U.S. RICs and REITs. The passive portfolio income earned by foreign corporations through those vehicles is effectively subject to only a single level of U.S. net taxation (collected in the form of a dividend withholding tax on distributions of net earnings from investments).

If the basic concept of a net-basis election were to be enacted, various choices present themselves in terms of operational details. One issue is whether the election would be available for all types of passive portfolio investments, or whether it would only be permitted for specific types of investments (presumably, those types for which the distortion from the inability to claim deductions is particularly egregious). While either approach would be an improvement over the present system, the authors see no reason not to make the election available for all types of passive portfolio investments. Taxpayers would always be free not to make the election for investments in which the associated expenses are sufficiently small that the administrative inconvenience of...
documenting the expenses and filing returns outweighs the benefit. A second issue is whether to require this type of election to apply to all investments of a foreign person that generate U.S.-source FDAP income, or whether, instead, the election would apply only for income and gains realized on specific investments identified as subject to the election at the time of acquisition. The authors favor the latter approach. Eligible investments would be limited to investments that generate U.S.-source FDAP income (base asset) and closely associated investments such as assets held to hedge the base asset or held in connection with the base asset as part of a broader arbitrage strategy. The election could not apply to payments received for nonportfolio investments and would not otherwise cause the foreign person to be subject to U.S. net taxation.

Yet another issue would be whether a taxpayer making the election would be entitled to claim all deductions allowable under the regular net-basis tax regime, or whether only limited deductions, to alleviate the most egregious aspects of gross taxation of U.S.-source FDAP income, would be permitted. The latter approach would sacrifice some degree of precision in the interest of simplicity. If this approach were adopted, an electing taxpayer should, at a minimum, be permitted deductions for depreciation and amortization on the base asset, and loss or expense for amounts directly associated with assets that are specifically identified as held in connection with the ownership of the base asset (that is, an investment held to hedge the base asset or held together with the base asset as part of a broader arbitrage strategy). A deduction should also be provided for interest expenses to third parties incurred on debt that is collateralized solely with property associated with the U.S. investment. An argument could be made for denying deductions for related party indebtedness — indebtedness that is generally recourse to the borrower or guaranteed by the borrower (except where the debt is incurred by a borrower that has no assets or activities other than holding property subject to the election). The normal antiabuse tax accounting rules would apply, including restrictions on losses from straddles, wash sale rules and constructive sales.

A major drawback of this type of regime is that it would require foreign portfolio investors to file a U.S. tax return, which many foreign investors would consider to be a substantial burden. In many cases, the election would be made by a fund or other pooled investment vehicle that has aggregated investments from many foreign persons. Nonetheless, in order to make the election more accessible to foreign persons who do not invest through a fund or pooled investment vehicle, and to ease the administrative complexities in identifying which positions are subject to net-basis elections, we would propose that consideration be given to the establishment of a new type of U.S. special purpose entity to hold passive portfolio investments. The vehicle would be established exclusively for use by foreign persons who are not engaged in a U.S. trade or business, and the vehicle itself would not be permitted to engage in any activity that would cause the vehicle to be treated as engaged in a U.S. trade or business if such vehicle were a foreign person. The vehicle would be subject to U.S. corporate net income tax at the highest marginal tax rates on all net income and gains, and provide for tax-free dividends to investors. Moreover, it would not be subject to either the accumulated earnings tax or the personal holding company tax. As with the proposed net income tax election, a single level of U.S. net tax is consistent with the fact that only a single level gross-basis tax is imposed under current law. In order to preserve the taxation of gains, tax-free liquidations of the vehicle would not be permitted.

The use of this type of single tax vehicle would provide substantially the same results as a net-basis election, while simplifying administration issues. It would also allow foreign persons to remain subject to U.S. gross taxation for assets acquired outside the vehicle. In addition, foreign investors reluctant to file U.S. tax returns might be more likely to make use of this type of single tax vehicle, instead of a direct net tax election, because the special vehicle rather than the foreign investor would file the return. Requiring that such a vehicle be organized in the United States is not inherently necessary, but would presumably facilitate administration and collection of tax by the United States.

The existence of a net income tax election or provision of a new special purpose vehicle to facilitate passive portfolio investment by foreign persons would add a certain amount of additional administrative burden on the IRS, but would also facilitate additional passive portfolio investment in the United States. Either option would presumably reduce the incentive for foreign persons to engage in aggressive tax planning to exploit loopholes in the current gross-basis regimes (including treaty shopping, use of derivatives, conduit structures, etc.). Accordingly, it might increase U.S. tax receipts.

C. Partnerships Engaged in a U.S. Business

1. Eliminate taxation of business income and/or gain from passive portfolio stakes in partnerships that are engaged in a U.S. trade or business. An important opportunity to simplify the U.S. international tax regime concerns the taxation of passive portfolio stakes in partnerships that are engaged in a U.S. trade or business, including partnership interests that trade publicly (for example, oil and gas master limited partnerships). As discussed above, under current law a foreign person who invests in such a partnership is treated as engaged in a U.S. trade or business, and accordingly is subject to net taxation on such person’s share of income from the partnership (whether or not distributed), as well as on other U.S.-source income that is treated as effectively connected under the residual force of attraction principle.

As discussed below, this assumes that the election is permitted to be made on an investment-by-investment basis.
In addition, the current position of the IRS is that such a taxpayer is also subject to net taxation of gains realized on the sale of an interest in the partnership (at least to the extent that gain is attributable to assets associated with the trade or business), although it is not entirely clear whether this position extends to publicly traded partnerships. A regular U.S. tax return must be filed. There is no exception for small portfolio interests in those partnerships. This system raises obvious administration and enforcement issues, especially because there is no withholding mechanism to collect tax on gains from the sale of partnership interests (except in the case where those gains are attributable to gain inherent in the U.S. real property interests held by the partnership).

Net taxation of passive portfolio investments in operating partnerships can be justified based on a desire to ensure at least one level of U.S. taxation of active business profits, although we note that the United States has ceded taxation on all business earnings paid to foreign persons in the form of interest. As discussed above, there are significant policy arguments in support of residence-based taxation generally, and significant administrative and simplification benefits to exempting tax on income from small portfolio interests in U.S. operating partnerships. At the minimum, an exception should be considered for the imposition of tax on gains from the sale of small portfolio stakes in publicly traded partnerships that are engaged in a U.S. trade or business. An exemption from tax on current income from these partnerships would provide incremental simplification benefits, and it is the authors' suspicion that the impact on tax collections would be relatively small.

2. Eliminate return filing requirement for passive portfolio interests in partnerships. If the United States is not willing to cede taxing jurisdiction entirely for operating income from partnerships engaged in a U.S. trade or business, it should still be possible substantially to simplify the administration and collection of tax on such income for passive portfolio investors. As discussed above, under current law becoming a partner, no matter how small, in a partnership which is engaged in a U.S. trade or business has two important collateral effects, in addition to net-basis taxation of income from that trade or business. Specifically, other U.S.-source income of the investor could become effectively connected (and hence subject to net-basis U.S. taxation) under the residual force of attraction principle, and the investor becomes responsible for filing U.S. tax returns. Eliminating those two collateral effects would simplify administration, and would also remove two major impediments to direct investments (that is, not through blocker corporations) in partnerships; at the same time, it would preserve tax revenues on income from the partnership’s business. The mechanical implementation of the proposal would be rather simple, particularly given that section 1446 already requires withholding on a foreign partner’s share of income from a partnership’s U.S. trade or business. The proposal would be to eliminate the trade or business attribution principle of section 875, as applied to passive portfolio investments. Instead, a separate tax (imposed at the maximum marginal rate) would be imposed, but only on the net income from the partnership’s trade or business (without a force of attraction principle). The tax would be collected by means of withholding (the mechanism for which already exists under section 1446). However, unlike current law, withholding would be the sole means of collection, so that foreign passive portfolio investors would not have to file U.S. tax returns.

There could be some practical difficulties in implementing a pure withholding-based collection system in the context of publicly traded partnerships. The reason is that in practice, withholding for publicly traded partnerships is usually done not by the partnership itself, but by the brokerage houses or other financial institutions through which partnership units are held. However, those institutions have no way of knowing about, or withholding from, undistributed income. In practice, when they receive a distribution from a publicly traded partnership on behalf of a foreign investor, in the authors’ experience they simply withhold 35 percent of the distribution.

Under current law, withholding on the basis of the amount distributed (rather than on all earnings, whether distributed or not) is specifically allowed by regulations applicable to publicly traded partnerships. However, because all partners are responsible for filing a tax return and paying the full amount of tax, the fact that no withholding is imposed on undistributed effectively connected income of a publicly traded partnership does not fundamentally change the timing of tax collections on such income — it just means that it is collected directly from the foreign partner, rather than withheld and remitted by the partnership (or a financial institution in the payment chain).

Under the authors’ proposal to make withholding the sole (or at least the primary) means of collection for tax on effectively connected income from passive portfolio investment in partnerships, this issue becomes more significant. Either (i) we would have to switch to a system in which foreign partners in publicly traded partnerships are only taxed when income is distributed (at which time the tax would be collected by withholding), or (ii) the financial community would have to develop a mechanism for handling withholding on undistributed income from publicly traded partnerships. Based on experience

58 See supra note 25 and accompanying text.

59 In theory, return filing (and direct payment of tax) could be required as a back-up mechanism if the partnership does not satisfy the obligation to withhold. This is analogous to the system currently in effect for FDAP withholding (i.e., return not required, if the substantive tax liability has been fully satisfied by withholding). However, given the reluctance of many foreign investors to engage in transactions that might require that they file U.S. tax returns, and given the likely small revenue effect, the authors believe that such a contingent return filing requirement is not warranted.

60 See supra note 27 and accompanying text. Interestingly, there is no such rule for section 1441 (FDAP) withholding, and the system that the financial community has developed for withholding does not appear to work properly in the case of publicly traded partnerships which have FDAP income.
with section 1441 withholding, it may very well turn out that, regardless of what the tax law says, the market might not develop such a system.

V. Conclusion

There are a number of aspects of the U.S. system of taxation of foreign persons who receive income from passive portfolio investment that can result in unfair (and sometimes bizarre) consequences for transactions commonplace in today’s economy. The authors suggest that the time has come to rethink some of the fundamental concepts underlying this system. Assuming that the United States is not willing to abandon source-based taxation entirely on income from passive portfolio investments, the authors suggest some basic approaches to improving the operation of the system.

The authors also suggest that, if Congress enacts legislation to prevent what may be perceived as abuses of the current system, it should also take the opportunity to examine improvements that could be made to the system itself. In particular, any legislation that made it more difficult for taxpayers to avoid the system, without also providing relief in those situations in which the system produces a patently unfair result, would not be wise tax policy.

SUBMISSIONS TO TAX NOTES

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