THE EXEMPT PORTFOLIO INTEREST SECTIONS OF THE INTERNAL REVENUE CODE AND THE UNDERLYING CAUSE OF THEIR EXISTENCE

NOTE

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I. INTRODUCTORY FRAMEWORK

The United States Taxation regime, on Inbound Taxation of foreign investors, has for the past few decades been concerned with two major focal points. These two main concerns pertain to the ascending collection of tax revenues[1] and the introduction of foreign capital, in reference to fiscal and economic aspects.

In order to develop the principal subject of this article, it is important to highlight and explain the nature of these two subjects, since it's precisely their conflicting nature what gives birth to the carefully crafted provisions of U.S. taxation framework regarding foreign investment. This paper will analyze how exactly these provisions are benefiting the U.S. taxation system and also stimulating foreign investment. All of this will be depicted in light of the tradeoff between inflation and unemployment rates that characterizes the monetary and fiscal policy concerns illustrated in the Philips' Curve.

We will also analyze the pros and cons of these provisions to both the U.S. tax regime and to foreign investors, applying close scrutiny to the general provisions as well as their practical effects on foreign investments.

II. INBOUND TAXATION OUTLINE

The U.S. Taxation regime is regulated by the Internal Revenues Code. In order to develop this article we need to directly compare and balance the ascending collection of tax revenue, as well as the introduction of foreign

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[1] JOSEPH ISENBERGH, INTERNATIONAL TAXATION 81-97 (3rd ed., Foundation Press 2010).

capital, in relation with the collection of tax revenue and the attractiveness of the dispositions of the tax regime to foreigners.

The Internal Revenue Code provides, in broad terms, that a foreign person is taxed at a flat rate of thirty (30) percent of their *gross* income derived from U.S. source passive investment.[2] Because this income is derived from predetermined and known sources, such as interests, dividends, rents and salaries, they are known as *fixed* or *determinable* income.[3] The regime is different, however, when the income is derived from business profits[4], which are taxed at full graduated rates on *net* profits.[5]

It is clear that these provisions would arise skepticism in any foreign citizen taking into consideration investing in a jurisdiction with a tax regime that doesn't have lower rate brackets for people like him and, additionally, imposes a thirty percent flat rate of their gross passive investment income.[6] Furthermore, following the 1986 Tax Reform Act, an additional tax of thirty (30) percent was imposed on the branch profits of foreign corporations in the United States when they are removed from U.S. business investments.[7] From this point of view, the scales shift up and down, respectively, between the tax regime and the introduction of foreign capital, while the collection of revenues outweighs the foreign capital concern. So the question arises, what incentive does a foreign citizen have to invest his capital in this scenario?

The answer to this question is found upon a closer study of the gaps in the flat rate tax on the investment of income of foreign persons. Other than real estate sales, capital gains from the sale of U.S. investment assets are exempt from taxation. Also, and very important, in order to appeal to foreign citizens, interest from U.S. bank deposits and from U.S. *portfolio* debt is also exempt from taxation.[8] This regulation also prevents foreign banks from gaining a competitive advantage over banks in the United States when making loans to American citizens outside of the United States. In this sense, professor Isenbergh stated the following:

> The overall pattern of U.S. taxation of foreign persons that emerges from these provisions is relatively benign taxation of passive

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[2] I.R.C §§ 871(a), 881 (2006).
[3] *Id.* at § 871(a)(1)(enumerating the items the flat rate tax regime applies to).
[4] Income that is effectively connected with the conduct of a trade or business in the United States.
[5] *Id.* at §871(b).*See also* § 882(a) and 884.
[6] *Id.* at § 873 & 882(c) (limitating deductions of foreign taxpayers to income effectively connected with a U.S. trade or business).
[7] *Id.* at § 47.
[8] ISENBERGH *supra*, note 1 at 82.

> investment income and more aggressive taxation of active business profits. This tax regime reflects, I believe, the combination of the large U.S. appetite for foreign capital that has developed in the last three decades and an accompanying wariness of surrendering day-to-day control over economic activity in the United States to foreigners. The need for foreign capital is the aftermath of American profligacy, both at home and abroad, that has transformed the United States since World War II from the world's largest exporter of capital to its largest importer.[9]

Upon reading this last statement, and the provisions of the Internal Revenue Code, it appears that the scales, in our comparison, shift in a different trend than before. This time substantial weight is added to the foreign capital concern in the American tax regime, while less importance is given to the concerns related to the collection of tax revenues. It's in this context that foreign citizens are more willing to invest in American banks and financial institutions, considering the attractiveness of an exempt *portfolio interest.*

III. THE EXEMPT PORTFOLIO INTEREST

The first item among the fixed or determinable income subject to U.S. taxation in the list of §871(a) of the Internal Revenue Code is interest. However, foreign persons are shielded from U.S. tax on interest received from a passive instrument and interest paid on deposits of U.S. banks or financial institutions.[10] The reason for this is the enactment of the Deficit Reduction Act of 1984[11] signed by President Reagan. By virtue of this act, particularly sections 871(h) and 881(c), professor Isenbergh explains, U.S. source interest from almost all types of debt obligations has been tax exempt for foreign persons. These provisions exempt from flat rate tax what they term *portfolio interest* received from the U.S. sources by foreign taxpayers.

A portfolio interest is defined as interest not derived from a U.S. business, paid on an obligation either in registered form with a foreign owner or issued with restrictions on U.S. ownership.[12] This is, in essence, interest resulting of a debt obligation held for investment by an identifiably foreign person and it is aimed to assure:

1. That the exemption is enjoyed only by actual foreign investors; and

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[9] *Id.*
[10] I.R.C § 871(i).
[11] Pub.L. 98-369, 98 Stat. 494.
[12] I.R.C. § 871(h)(2) (defining *portfolio interest*).

2. That the relationship between the borrower and the lender truly is a portfolio interest and not product of an active business.[13]

Almost any kind of obligation by debt (bonds, notes and even properly recorded debt on open account that is unrelated to business) can qualify to be tax exempted. Naturally, temptation arises for the entrepreneurial and logical individuals, who will try to get around it by presenting their U.S. assets as passive investment instruments.

There are a few exceptions with the purpose of creating limitations to prevent these situations such as the ten (10) percent shareholder limitation, which excludes any interest received by a "10 percent shareholder"[14] of the debtor[15] to prevent tax evasion paid by a corporation to its owners and substantial equity holders. Without this limitation, the tax exemption of a portfolio interest would be an open door for foreign investors to escape U.S. taxation.

Another important exception is that interest received by a bank "on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business"[16] is not exempt portfolio interest. Naturally, the nature of this loan makes it look more like a business transaction than a passive investment. However, Professor Isenbergh noted that foreign banks can receive exempt portfolio interest on *bona fide* passive investments, such as corporate bonds and U.S. Treasure debt. Also, he suggested that income tax treaties may shield some interest received by foreign banks that do not qualify as exempt portfolio interest.

It should be noted, by this point, that the U.S. tax regime shields only passive investment and excludes any investment that is, in its essence, a business transaction. Thus the reason why sales of real estate cannot be exempt from U.S. taxation, for its essence is more of a business transaction than that of a passive investment.

IV. REASONING AND ANALYSIS OF THE PORTFOLIO INTEREST TAX EXEMPTION

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[13] *Id.*

[14] *Id.* at §871(h)(3)(b). (The term ``10-percent shareholder'' means (i) in the case of an obligation issued by a corporation, any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote, or (ii) in the case of an obligation issued by a partnership, any person who owns 10 percent or more of the capital or profits interest in such partnership.

[15] *Id.* at §871(h)(3).

[16] *Id.* at §881(c)(3)(a)

Following Professor Isenbergh's reasoning, and his statement asserting that the United States transformed from the biggest exporter to the biggest importer in the world, it is clear that the reasoning for portfolio interest to be tax exempted is that of creating equilibrium between the collection of tax revenues and the stimulation of foreign investment. In other words, the United States taxation regime is designed to appeal to foreign investors by offering tax exemptions on their passive investments and, therefore, trading off some of the collecting tax revenue concern for a higher rate of foreign investment. This reasoning was ratified in the ruling of *Central de Gas de Chihuahua v. Comm'r*,[17] which was a case of a Mexican corporation in the United States that realized transportation of petroleum from different sectors of the U.S. to the border of Mexico. Central de Gas rented a fleet of tractors and trailers to another Mexican corporation, Hidro Gas de Juárez, S.A. Problems arose when Hidro defaulted on its obligation to pay rent to Central de Gas, which was due by the end of the fiscal year of 1990, and the Mexican corporation had incorrectly deducted thirty (30) percent off its Federal income tax return.

Regarding this aspect, the Judge asserted the following:

> Petitioner did not file a Federal income tax return for 1990. Respondent, acting under section 482, allocated to petitioner the amount of $2,320,800 as the fair rental value of the equipment for 1990 (which the parties now agree should be $1,125,000) and determined that petitioner was liable for the 30-percent tax imposed by section 881 on that amount, which is the primary position respondent asserts herein. Respondent also asserted in the deficiency notice and asserts herein, as an alternative position in the event that we should grant petitioner's motion, i.e., hold that the section 881 tax does not apply, that petitioner is liable for tax under section 882 on income effectively connected with the conduct of trade or business within the United States.[18]

This particular case is important since in the listing of tax exempted passive investments of a portfolio interest, the concept of "rents"[19] happens to be among the very first items in the list. The ruling of this case, however, was ultimately based on the fact that the foreign Corporation (Chihuaha) rented equipment to another foreign corporation to transfer petroleum to the border of Mexico, that is, to be used within the United States. The Court unequivocally determined that, in this particular case, the rents in question

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[17] Central de Gas de Chihuahua v. Comm'r, 102 T.C. 515 (1994).
[18] *Id.* at 516.
[19] I.R.C. § 871(a)(1).

constituted part of a trade or business transaction within the United States. In conclusion, two foreign corporations that are carrying out any type of business or trade, are not tax exempt in the United States as to portfolio interest, because these limitations and restrictions are precisely what the aforementioned provisions are for.

In *Commissioner v. Wodehouse*[20], the Court ruled that sums received for the use of copyrights by a nonresident foreign author, who is not engaged in trade or business within United States and who does not have an office or place of business therein, are accounted in calculating the gross income for federal tax purposes.[21]

More specifically, the Court stated:

> Rentals and royalties paid for the use of or for the privilege of using patents, copyrights, and other like property in the United States have long been taxed to nonresident aliens and for many years at least a part of the tax has been withheld at the source of the income, and therefore this type of income would not be exempted from taxation in 1938 or 1941, in absence of clear and positive legislative determination to change the established procedure….Where nonresident alien author not engaged in trade or business in United States and not having an office or place of business therein sold the exclusive serial rights in stories to domestic magazine publisher which agreed to obtain copyright and after publication to reassign all rights to author except American serial rights, lump-sum payments made in advance to author in 1938 and 1941 were not exempt from income tax as proceeds from sale of personal property but were taxable as "royalties" under statute imposing tax on income received by nonresident aliens as fixed or determinable annual or periodical gains, profits, and income.[22]

The facts of *Wodehouse*[23] are fairly simple. A foreign author sold the right to serialize a novel to an America magazine publisher for a lump sum price. The I.R.S. claimed that even if it was a single payment, it was nonetheless fixed or determinable income subject to the flat rate tax. The Court then ruled in favor of the I.R.S. insofar it solved that in the transfer process of said serial rights Wodehouse retained so many other rights regarding the property that there had been no sale to begin with. Since the

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[20] Commissioner v. Wodehouse, 337 US 369 (1949).
[21] Revenue Act 1938, 26 U.S.C.A. §§ 119 (2006). *See* also § 211- 212(a).
[22] *Id.*
[23] Commissioner v. Wodehouse, 337 US 369, 377-383 (1949).

ruling of this case in 1939, a sale and a license are considered to be different, not on the form of payment but to the extent of the rights transferred in the underlying property. Professor Isenbergh expressed that "the outcome of *Wodehouse* left opportunities for foreign taxpayers. As long as they transferred substantial and extensive U.S. rights in intangible property, their transactions were [considered to be] sales"[24] regardless of it being transferred with a single payment or subsequent stream of payments for the buyer's use of the property.

The Court in this case dealt with a problem, regarding income originated from or by intangible property. The difference between "sales" and "licenses" of intangible property is not that complicated depending on the circumstances. As illustrated by the Court, "[a] transfer of a copyright forever, lock, stock, and barrel, with no retained right of use, has always been a sale. The nonexclusive permission to use a secret process in exchange for a percentage of the resulting sales has never *not* been a license."[25]

At this point, we can easily infer that the U.S. taxation regime (and the portfolio interest on passive investment exemption) is focused in the capitalization of the United States banks from foreign investors and the consequent prevention of foreign banks from gaining a competitive advantage over U.S. banks. The lower credits are a result of less foreign taxes being paid by U.S. taxpayers on their foreign source income.

In general, low or zero withholding tax rates are usually designed to attract foreign individuals and corporations to invest through the tax haven, rather than to provide a tax benefit for their own residents, although many tax haven countries have low tax rates in an effort to attract real productive investment into the country.[26]

Margaret P. Lewis, an official working for the I.R.S. at the time of the enactment, published a good analysis and study of the effects and the reasoning for the Deficit Reduction Act of 1984. In reference to the Act and its repercussions, Mrs. Lewis expressed the following statement:

> Almost 70 percent of the increase in U.S. source income paid to foreign persons was accounted for by interest payments. The Deficit Reduction Act of 1984, which became effective on July 18, 1984, exempted most types of interest payments to foreigners from U.S. tax withholding. Not all of this increase can be attributed to the enactment of this legislation, however, since only interest paid on obligations issued after July 18, 1984, was entitled to this exemption. During 1984 high U.S. interest rates helped make investment in the

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[24] ISENBERGH *supra*, note 1 at 19.
[25] ISENBERGH *supra*, note 1 at 95.
[26] MARGARET P. LEWIS, FOREIGN RECIPIENTS OF U.S. INCOME, AND TAX WITHHELD 61-70 (1984).

> United States more attractive to foreign investors who thus helped finance an expanding U.S. economy. The growing U.S. economy also attracted foreign investment as the dollar appreciated against major currencies. Moreover, the large U.S. trade deficits put "strong dollars" into the hands of foreigners who in turn invested them in the United States.
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> High U.S. interest rates, a growing U.S. economy and enactment of the Deficit Reduction Act of 1984, which exempted most types of interest from tax withholding, all contributed to a 57 percent rise in U.S. source income paid to foreign persons in 1984. Interest remained the most common type of income, rising to 59 percent of total income even though it only ac-counted for 21 percent of tax withheld. Foreign corporations remained- the biggest recipients of U.S. source income, receiving 68 percent of all income paid in 1984. Individuals received only 7 percent of income yet accounted for 15 percent of tax withheld. This was because individuals received more dividend income (which is rarely tax-exempt) than interest or any other income type.[27]

Upon consideration and analysis of the previously discussed jurisprudence, as well as the opinions and doctrines presented by Professor Isenbergh and the study presented by Mrs. Lewis, it is clear that the reasoning behind the enactment of these exemptions came as a result of a macroeconomic growth in the United States which intended to keep growing by making investment more appealing for foreign citizens with less strong currency. A glimpse of macroeconomic models and theories could reasonably explain the intention of the enactment of these exemptions.

For instance, the simplest Keynesian model of macroeconomic activity is illustrated by the following formula: $Y = C + I + G + Nx$. In this formula Y represents the total output (or Gross domestic Product) of a certain economy, C represents the general consumption of goods, I represents private sector investment, G represents government expenditure and Nx (Net exports) represents the difference between exports and imports.[28]

The enactment of the tax exemptions could be explained by asserting that the U.S. tax regime was aiming for a substantial increase in the private sector investment (i.e. "*I*") by making foreign citizens feel attracted by the high interest rates that their investments would gain in the U.S. without having to pay taxes. This would result in a substantial increase in their total

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[27] *Id.* at 70.
[28] N. GREGORY MANKIW, MACROECONOMICS 25-33 (Worth Publishers 6th ed. 2007).

output (i.e. "*Y*") and, consequently, a substantial and sustained economic growth of the United States economy.

For these reasons, it is my opinion that the reasoning behind the *portfolio interest* tax exemption was originally enacted to attract substantial investment from other economies, by enticing foreign citizens to invest in a promising and growing economy with interest rates that would derive higher income and be tax exempted in contrast to investing in their own economy. Finally, taking a look at our hypothetical balance of concerns, it seems that there is indeed a tradeoff between collecting tax revenues and stimulating foreign investment, but that this tradeoff would not result in a significant loss of tax collecting revenues, at least in the long run. That is, despite of the increase in the total output (G.D.P.), the substantial increase in private sector investing derived from foreign investors would compensate for it. After all, the higher the increase in the Gross Domestic Product of this economy, the greater the incomes of the labor sector will be and thus the tax collecting revenue would be satisfied with higher amounts of taxable incomes.