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ALTERING U.S. TREATY POLICY TO PERMIT THE NEGOTIATING OF ZERO WITHHOLDING ON PORTFOLIO DIVIDENDS: AN INVITATION TO RESEARCH

by J. Clifton Fleming, Jr.

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The U.S. corporate sector is an enormous capital importer. Regrettably, American federal tax law substantially encourages these financial inflows to be structured as portfolio holdings of U.S. corporate debt rather than as investments in U.S. corporate shares.[1] Part of this systemic bias results from the fact that corporate interest payments are usually deductible under the federal income tax but dividend distributions are not. Thus, interest payments do not bear the U.S. corporate income tax, while dividends must be distributed out of corporate receipts, which have been subjected to a 34-percent tax. However, another major contributor to the bias in favor of portfolio debt[2] is the U.S.' decision in 1984 to statutorily drop the withholding tax rate to zero on interest (including original issue discount) received by foreigners with respect to their portfolio holdings of American corporate debt.[3] In contrast, gross dividends paid to foreigners on U.S. portfolio stock[4] investments are subject to a 30-percent statutory withholding rate,[5] which is usually reduced to 15 percent in bilateral treaties.[6]

Foreign investors presumably respond to these factors by substituting portfolio investments in U.S. corporate debt for purchases of portfolio equity.[7] To the extent that foreigners behave in this way,[8] U.S. corporations are more leveraged than they would otherwise be,[9] and the federal income tax base is eroded by interest payments that bear a zero tax rate both at the cor-

[1]Department of the Treasury, "Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once," 49, 74 (1992) (hereinafter cited as "Treasury Integration Report").

[2]When used in this paper with respect to debt, the term "portfolio" means corporate debt that is held as a passive investment by a traditional unrelated investor as opposed to a loan by a bank or by a substantial shareholder of the debtor.

[3]Sections 871(h) and 881(c). All statutory references are to the Internal Revenue Code of 1986.

[4]When used in this paper with respect to stock, the term "portfolio" means stock that represents such a small percentage of the issuer's voting shares that the owner has no meaningful influence over the issuer. *Compare* United States-Canada Income Tax Treaty X.2.(a).

[5]Sections 871(a)(1) and 881(a)(1).

[6]*See*, e.g., United States-Canada Income Tax Treaty X.2.(b). Furthermore, a 15-percent treaty withholding rate on dividends appears to be an international standard. ALI Federal Income Tax Project, Tentative Draft No. 16, United States Income Tax Treaties 184 (1991) (hereinafter cited as "ALI Tax Treaty Report").

[7]Foreign banks borrow funds and relend them to U.S. corporations, thus incurring substantial interest costs that arguably make a 30-percent or 15-percent withholding tax on gross interest an inappropriate levy. However, there would appear to be no difference between the costs of investors in portfolio debt and investors in portfolio shares. *See* notes 2 and 4. Thus, the dramatically more generous tax regime for portfolio debt investments creates a clear preference for such investments over corporate share purchases.

[8]Some foreigners continue to buy corporate shares in the face of these facts. Treasury Integration Report 49. These investors are given a structural incentive to purchase growth stocks instead of dividend-paying shares because capital gains realized by foreigners on stock sales are usually exempt from U.S. tax. Section 871(a)(2); Treas Reg section 1.1441-2(a)(3); 1 Joseph Isenbergh, *International Taxation* 238 (1990). As a result of this treatment of capital gains, foreign investors in U.S. growth stocks can create a tax-free cash flow by periodically selling part of their shares. To this extent, portfolio stock investments receive tax treatment equivalent to the tax treatment of portfolio debt investments. However, there is no reason for such a dramatic structural bias against shares that pay regular dividends. Furthermore, market conditions and investor objectives will make growth stocks unattractive at times, thus effectively limiting foreign investors to a choice between debt instruments and dividend-paying shares.

[9]The increased corporate debt burden resulting from the income tax system's preference of corporate debt over corporate equity is widely regarded as distorted investor behavior that results in an efficiency loss. *See* Treasury Integration Report 115-16; ALI Federal Income Tax Project, Tax Advisory Group Draft No. 21, Reporter's Study 34-37 (1992); ALI Federal Income Tax Project, Reporter's Study Draft, Subchapter C (Supplemental Study 39-40 (1989).

porate payor level and in the hands of the foreign investor.

The bias described above could be mitigated by disallowing any deduction for U.S. corporate interest payments on foreign-held portfolio debt. This would expand the current section 163(j) treatment of tax-exempt interest payments to foreign related parties by overleveraged U.S. corporations.[10] However, even after interest deduction disallowance, a significant structural bias in favor of foreign-held debt would still remain because the foreign distributees of dividends on U.S. portfolio equity would face a 30- or 15-percent U.S. withholding tax whereas the foreign recipients of interest on U.S. portfolio debt would pay no U.S. tax.

The federal income tax base is eroded by interest payments that bear a zero tax rate both at the corporate payor level and in the hands of the foreign investor.

This latter bias against dividends could obviously be overcome by imposing an appropriate withholding tax on outbound interest payments. Unfortunately, when the Federal Republic of Germany did so in 1989, the access of German borrowers to international capital markets was substantially curtailed and the withholding tax was promptly repealed.[11] The world of international finance has evolved to a competitive standard of zero withholding on portfolio interest and any contrary unilateral move by the U.S. would presumably cause the German experience to be replicated. Stated differently, it does not seem feasible to address the tax system's bias in favor of foreign-held U.S. corporate debt by imposing a withholding tax on outbound interest payments.[12]

An alternative is to negotiate with our treaty partners to reciprocally reduce the withholding rate on portfolio dividends to zero.[13] Outbound portfolio interest and dividends would then receive identical withholding tax treatment. This would, of course, result in a loss of the current 30- or 15-percent dividend withholding tax revenue. However, U.S. equity investments would be more attractive, and even if interest payments remained fully deductible, every foreign investor who switched from U.S. corporate debt to U.S. equity would be switching from an investment that bears a zero tax rate at the corporate level to an investment that bears a 34-percent corporate-level tax. Thus, an ameliorating revenue pickup would occur.[14] Furthermore, if disallowance of the deduction for corporate interest payments on foreign-held U.S. corporate debt were implemented[15] at the same time as the proposal for negotiating zero dividend withholding in bilateral tax treaties, the loss of dividend withholding revenue would be at least partially paid for by the revenue gain from the new 34-percent corporate level tax on funds used to make outbound interest payments.[16] It would indeed be useful for econometricians to estimate the effects of these revenue losses and gains to determine the extent to which bilateral treaty reductions of the dividend withholding rate to zero would impose a revenue cost on the income tax system.

[10]However, this approach would mean that deductible corporate interest payments to U.S. debtholders would be taxed at the debtholder's marginal rate whereas nondeductible payments of tax-free portfolio interest to foreign debtholders would be taxed at the corporate debtor's marginal rate. This is not an attractive outcome. Furthermore, foreigners would respond by making loans to noncorporate U.S. taxpayers who would relend the money to U.S. corporations. The complexities of a lookthrough rule would be required to combat this tactic. *Compare* the U.S. Treasury's recent Comprehensive Business Income Tax proposal, which would generally make all corporate interest payments nondeductible but tax-free. Treasury Integration Report 40-41, 48-49, 80.

[11]ALI Tax Treaty Report 194 n.515.

[12]*See* ALI Tax Treaty Report 194-95; Staff of Joint Comm. on Tax'n, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 391-92 (Comm. Print 1984).

[13]While the following analysis might support the U.S.' unilateral abandonment of dividend withholding, it seems better for the U.S. to extract reciprocal concessions through bilateral negotiations. *See generally* Treasury Integration Report 48-49, 79-80; ALI Tax Treaty Report 184.

[14]This is not to assert that the revenue pickup would be sufficient to eliminate the withholding tax loss or to produce a net revenue gain. The suggestion is merely that the revenue loss from eliminating dividend withholding would be lessened by an offsetting gain. For a more detailed analysis, *see* Treasury Integration Report 151; Alan J. Auerbach, "Corporate Restructuring: Tax Incentives and Options for Corporate Tax Reform," 43 *Tax Law.* 663, 665-66 (1990).

[15]*But see* note 10.

[16]*See* note 14.