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Financing Foreign Investment in the United States

Craigh Leonard

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Financing Foreign Investment in the United States

by Craigh Leonard*

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   preparation of this article.
The purpose of this article is to examine some of the issues that commonly occur when a foreigner wishes to capitalize a business venture in the United States. The principal questions in this area generally arise under U.S. laws relating to capital formation, taxation, disclosure requirements and currency and asset controls. Accordingly, this article will focus on four main topics: (1) the extraterritorial effect of federal securities laws and the margin regulations; (2) federal laws relating to movements of currency and monetary instruments; (3) corporate and tax considerations relating to preserving the anonymity of foreign investors; and (4) U.S. taxation of foreign investment.

I. Capital Formation

A. The Extraterritorial Effect of U.S. Securities Laws

If a foreigner wishes to establish a business venture in the United States and plans to capitalize the venture solely from his own funds, it is unlikely that the U.S. federal securities laws will apply to the transaction. If, however, the foreigner wishes to raise money from others, whether located in the United States or abroad, some consideration must be given to the effect of the federal securities laws on the foreigner's proposed conduct.

The federal securities laws contain two main categories of rules governing offers and sales of securities: the registration requirements under the Securities Act of 19331 (the "Securities Act") and the anti-fraud rules under the Securities Exchange Act of 19342 (the "Exchange Act"). The extent of the applicability of the registration requirements to offers and sales of securities outside of the United States is relatively clear. The extraterritorial effect of the anti-fraud rules, however, has not yet been fully defined. The uncertain scope of these rules may lead to entirely unexpected liability for a foreign investor arising from securities transactions between foreigners involving foreign securities even in transactions appearing to have only minimal U.S. contacts. It should be noted that this type of liability may also attach to the foreigner's U.S. advisors, including his lawyers and accountants.3

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(1) The Registration Requirements. Section 5(c) of the Securities Act makes it unlawful to offer to sell any security unless a registration statement relating to the security has been filed with the Securities and Exchange Commission (SEC). Section 5(a) of the Securities Act makes it unlawful to sell any security unless a registration statement relating to the security has been filed with the SEC and has become effective. There are, of course, certain well-known exemptions from these requirements. However, if these exemptions are not available with respect to a particular transaction, the extraterritorial reach of registration requirements must be examined.

As a starting point, it is clear that the registration requirements apply to offerings in interstate commerce of both U.S. and foreign issuers. Accordingly, the fact that securities of a foreign corporation or other form of foreign business enterprise are being offered and sold does not provide an exemption. If registration of securities of foreign issuers is required, private foreign issuers ordinarily register in the same manner as private U.S. issuers. Special forms and rules are provided for the registration of the securities of foreign governments.

In order for the registration requirements to apply, securities must be offered and sold in "interstate commerce." This term includes communication between "any foreign country and any state." Accordingly, the potential sweep of the registration requirements is very broad and could include sales of U.S. and foreign securities made abroad if any use of "interstate commerce" is made. The view of the SEC, however, is that the principal purpose of the registration requirements is to protect American investors. The SEC traditionally has not taken any action for failure to register securities of U.S. corporations distributed abroad so long as the offerings are made under circumstances reasonably designed to preclude distribution of the securities within or to nationals of the

5 Securities Act of 1933, supra note 1, § 5(a) (codified at 15 U.S.C. § 77e(a)(1) (1976)). A registration statement filed under the Securities Act becomes effective no later than 20 days after it is filed unless its effectiveness has been delayed by an order of the Securities and Exchange Commission (SEC). See id. § 8(a) (codified at 15 U.S.C. § 77h(a) (1976)). In order to give the SEC sufficient time to review registration statements, issuers customarily file delaying amendments pursuant to 17 C.F.R. § 230.475 (1981). When the registration statement has been prepared in final form, the issuer then requests acceleration of the effective date pursuant to 17 C.F.R. § 230.461 (1981).
United States. Thus, securities of a U.S. business enterprise could be offered and sold to the public outside of the United States without violating section 5 of the Securities Act, provided adequate precautions are taken that the securities offered and sold outside of the United States do not "flow back" to this country.

In the case of a non-underwritten offering of U.S. securities abroad, the SEC has found that the following "flow back" precautions are sufficient: (1) the issuer imposes an absolute prohibition on any transfer of the securities for a period of ninety days after the initial distribution; (2) transfers made after the expiration of the ninety day period are prohibited unless the issuer's counsel is satisfied that the transfer would not violate the registration requirements; and (3) the stock certificate issues in the distribution bear restrictive legends. Similar but expanded procedures have been found to constitute adequate "flow back" precautions in an underwritten public offering of U.S. securities in Europe. Presumably, these positions taken by the SEC with regard to offering of U.S. securities abroad would apply as well for foreign securities offered and sold abroad through the use of interstate commerce.

A willful failure to register securities is a criminal offense. In addition, a purchaser of a security sold in violation of the registration provisions has the right to rescind the transaction, or to recover damages if he has sold the security, provided an action is brought within one year of the unregistered sale. It should be noted that the penalties and liabilities for violation of the registration provisions are independent of the anti-fraud rules of the Securities Act and apply irrespective of whether any fraudulent misstatements were made in connection with the offering.

(2) The Anti-Fraud Rules. Sections 12(2) and 17(a) of the Securities Act and Section 10 and Rule 10b-5 under the Exchange Act generally prohibit material misstatements and fraud in connection with offers and sales of securities in interstate commerce. As noted above, the extraterritorial scope of the anti-fraud rules is considerably less certain than the scope of the registration requirements, although it appears clear that
Congress did intend the anti-fraud rules to have extraterritorial application.\textsuperscript{19} In addition, the SEC has not yet attempted to clarify this area through the exercise of its rule-making power.\textsuperscript{20}

The anti-fraud rules are only applicable if use of interstate commerce is made in connection with a particular transaction.\textsuperscript{21} In this regard, the use of the mails or telephone clearly involves interstate commerce\textsuperscript{22} and the conducting of negotiations in the United States or the employing of U.S. lawyers or accountants\textsuperscript{23} probably would involve sufficient use of interstate commerce to satisfy this jurisdictional requirement. Accordingly, most cases involving the purchase and sale of securities by a foreigner in connection with the financing of a business enterprise in the United States are likely to involve interstate commerce and thus be potentially subject to the anti-fraud rules. It might be noted here that the courts have never limited application of the anti-fraud rules to purchases and sales of U.S. securities. Thus, purchases and sales of the securities of both U.S. and foreign issuers are potentially subject to these rules.\textsuperscript{24}

This article will not address the type of conduct necessary to support an allegation under the anti-fraud rules. Instead, the focus of this discussion will be on what factors guide the courts in determining whether jurisdiction exists to hear such an action. For example, two cases have posed the hypothetical question of whether jurisdiction would exist to hear a case where "a German and a Japanese businessman met in New York for convenience, and the latter fraudulently induced the former to make purchases of Japanese securities on the Tokyo stock exchange."\textsuperscript{25}

The courts' analyses of the jurisdictional scope of the anti-fraud rules have proceeded largely through the application of a "conduct" test and an "effects" test. The effects test can be illustrated by 	extit{Schoenbaum v. Firstbrook}\textsuperscript{26} which involved a derivative action by U.S. shareholders of a Canadian corporation whose stock was listed on the American Stock Exchange. The transaction in question was based upon a sale in Canada to foreign purchasers of stock of the Canadian corporation. The sale allegedly involved the misuse of insider information. Accordingly, the transaction involved foreign buyers and sellers of foreign securities in a transaction closed outside the United States; in addition, no fraudulent conduct was found to have occurred in the United States. Nonetheless, subject matter jurisdiction was found under the anti-fraud rules because

\textsuperscript{20} IIT v. Cornfeld, 619 F.2d 909, 912 n.2 (2d Cir. 1980).
\textsuperscript{21} See 2 L. Loss, Securities Regulation 1169-70 n.2 (2d ed. 1961).
\textsuperscript{22} See 405 F.2d at 200.
\textsuperscript{23} See 405 F.2d at 207 n.2.
\textsuperscript{24} 468 F.2d at 1336.
\textsuperscript{25} Grunenthal GmbH v. Hotz, 511 F. Supp. 582, 583 (C.D. Cal. 1981); 468 F.2d at 1338.
\textsuperscript{26} 405 F.2d at 200.
of the "sufficiently serious effect upon United States commerce" that might occur if the value of the company's stock listed on the American Stock Exchange declined as a result of the transaction.

Although it seems to be an accepted principle of international law that a state has the power to enact laws governing acts outside its territory which cause consequences within its territory, several cases subsequent to Schoenbaum have indicated that the somewhat speculative U.S. effects found in Schoenbaum may represent the outer limit of what is necessary for subject matter jurisdiction to attach under this test. For example, the unspecified and generalized adverse impact on the U.S. securities markets occasioned by the collapse of the Investors Overseas Services mutual funds was not a sufficient U.S. effect on which to base subject matter jurisdiction. Furthermore, in Leasco Data Processing Equipment Corp. v. Maxwell, insufficient U.S. effects were found where a single U.S. investor was defrauded in connection with a purchase of English securities in England.

Leasco concerned a foreign seller of foreign securities who was alleged to have made "substantial misrepresentations" in the United States. As indicated, the court expressed its doubt as to whether the U.S. effects in Leasco were sufficient for jurisdictional purposes. The court found, however, that the alleged conduct in the United States was a sufficient basis for jurisdiction under the anti-fraud rules.

The level of conduct in the United States necessary to support subject matter jurisdiction was examined in two important cases subsequent to Leasco. Bersch v. Drexel Firestone, Inc. concerned an underwritten public offering in Europe of securities of a Canadian corporation. The court found that no sufficient conduct had occurred in the United States to support jurisdiction of the claims of foreign investors. The U.S. acts that did occur were described as "merely preparatory or take the form of culpable nonfeasance and are relatively small in comparison to those abroad." The "merely preparatory" acts of Bersch may be contrasted with the allegations in Vencap, Ltd., where all of the significant acts concerning the transaction were alleged to have occurred in the United States. Even though the persons affected in Vencap all were foreign persons and thus no U.S. effects were found, the court found juris-

27 Id. at 209.
29 519 F.2d at 989.
30 468 F.2d 1326 (2d Cir. 1972).
31 Id. at 1334.
32 Id. at 1337.
33 519 F.2d 974 (2d Cir. 1975).
34 These acts included meetings in the United States of the major underwriters with their lawyers and accountants, and the reviewing of drafts of a prospectus in the United States and the deposit of the proceeds of the offering in a U.S. bank. Id. at 985 n.24.
35 Id. at 987.
36 519 F.2d 1001 (2d Cir. 1975).
diction because the alleged conduct amounted to a perpetration of the fraud from the United States. The court stated, "[w]e do not think Congress intended to allow the United States to be used as a base for manufacturing fraudulent securities devices for export even when they are peddled only to foreigners."\(^{37}\)

The court in Bersch also addressed the question of whether the conduct and effects tests should be applied differently depending upon the class of persons making the claim. It answered this question affirmatively by holding that there was sufficient U.S. conduct to support jurisdiction over claims made by American investors but not over claims made by foreigners.\(^{38}\) In reaching this admittedly unsupported result,\(^{39}\) the Bersch court concluded that the anti-fraud rules of the federal securities law:

1. Apply to losses from sales of securities to Americans resident in the United States whether or not acts (or culpable failures to act) of material importance occurred in this country; and
2. Apply to losses from sales of securities to Americans resident abroad if, but only if, acts (or culpable failures to act) of material importance in the United States have significantly contributed thereto; but
3. Do not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses.\(^{40}\)

This unsupported assertion by the Bersch court that the anti-fraud rules may be applied differently depending upon whether the victims are U.S. or foreign residents has found support in later cases.\(^{41}\)

It is apparent that the courts are still in the process of defining the scope of the conduct-effects test. In dealing with a fact situation almost identical to the meeting of the German and Japanese businessmen described at the beginning of this section, a district court in the Ninth Circuit has found no subject matter jurisdiction.\(^{42}\) The district court speculated, however, that the Eighth Circuit might find jurisdiction in the German-Japanese hypothetical case because of that circuit's more liberal view of jurisdictional requirements in the area.\(^{43}\) Accordingly, although useful guides do exist, it will remain difficult to predict with any certainty whether the anti-fraud rules apply to many transnational securities transactions.

(3) Definition of a Security. Because of the wide scope of foreign business interests in the United States, it may be useful to describe briefly

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\(^{37}\) Id. at 1017.

\(^{38}\) 519 F.2d at 992.

\(^{39}\) Id. at 993.

\(^{40}\) Id.


\(^{43}\) Id. at 588, citing Continental Grain (Australia) Pty. Ltd. v. Pacific Oilseeds, Inc., 592 F.2d 409 (8th Cir. 1979).
the application of the U.S. securities laws to forms of investment which may not readily appear to be subject to these laws. Both the registration and anti-fraud rules discussed above apply only to offers, purchases or sales of a security. If a security is not involved in the transaction, the registration and anti-fraud rules will not apply.

The definition of a security under both the Securities Act and Exchange Act includes stock and promissory notes. The definition, however, is not limited to these traditional instruments and may include interests in land or tangible personal property, such as gold, sought to be sold by a foreigner in or from the United States.

Both the Securities Act and the Exchange Act define the term "security" to include an investment contract. In SEC v. W.J. Howey Co., the United States Supreme Court found an investment contract to be comprised of three elements for purposes of the Securities Act: (1) an investment of money, (2) in a common enterprise, (3) with an expectation of profit solely from the efforts of others. Based on these tests the Court in Howey found that an offer to sell a portion of the land in an orange grove was an offer of a security when coupled with an offer by an affiliate of the seller to farm the land pursuant to a joint venture with the other owners of the grove.

The three-pronged analysis in Howey is the most important test in determining the existence of a security for purposes of the Securities Act and the Exchange Act. A detailed examination of the test is beyond the scope of this article. It should be mentioned, however, that the issue that is most often litigated in the Howey test is the issue of the expectation of "profits solely from the efforts of others." In addition, one aspect of the analysis of this test may have particular relevance to foreign investors.

The question that arises in this regard is whether a security is involved if the investor is asked, or has the power, to exert any management control over the venture. If this power exists, then it is arguable that the investor cannot expect profits "solely from the efforts of others." For example, a restaurant franchise agreement was found not to be a security where the franchisor was to provide substantial services but the

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47 328 U.S. 293 (1946).
48 Id. at 298-99.
49 For an overview of the history of the analysis of this test, see Union Planters Nat'l Bank v. Commercial Credit Bus. Loans, Inc., 651 F.2d 1174 (6th Cir. 1981); Hector v. Wiens, 533 F.2d 429 (9th Cir. 1976).
50 See, e.g., Williamson v. Tucker, 645 F.2d 404, 418 (5th Cir. 1981).
franchisee was to exercise meaningful controls.\textsuperscript{51} Nonetheless, it is clear that investor participation in the venture will not preclude the finding that a security exists, and in its most recent analysis of an investment contract, the Supreme Court omitted the word "solely" from the definitional requirement that an investor must expect profits from the efforts of others.\textsuperscript{52}

It is generally true that general partnership interests and joint ventures do not constitute securities for these purposes.\textsuperscript{53} This presents the possibility that business ventures such as real estate and oil and gas ventures, in which foreign investors commonly participate as limited partners, could be structured as general partnerships in order to avoid the impact of the securities laws. Presumably the promoter or manager of such a venture would not mind having foreign participants as general partners if he felt that their geographic isolation effectively precluded them from exerting meaningful control over management of the venture.

Nonetheless, the mere fact that an investment takes the form of a general partnership interest or joint venture does not invariably insulate it from the reach of the federal securities law. One case involving a general partnership formed to hold and develop vacant land has held that if a general partner has irrevocably delegated his powers, or is incapable of exercising them or is so dependent on the particular expertise of the promoter or manager that he has no reasonable alternative to reliance on that person, then an investment contract security may exist.\textsuperscript{54} These factors seem particularly likely to exist in connection with sales of general partnership interests to nonresident aliens. Accordingly, particular attention should be paid to this aspect of the Howey test in connection with offers and sales of general partnerships or joint venture interests to such persons.

\textit{B. Margin Regulations}

The margin regulations limit the amount that can be borrowed or lent to purchase securities that are registered on U.S. national securities exchanges or that are traded in the over-the-counter market.\textsuperscript{55} In general, the maximum amount that can be borrowed or lent for these purposes is limited to fifty percent of the value of the security to be purchased.\textsuperscript{56}

These rules are set forth in four regulations. Three regulations, Regulations G, T and U, govern lenders, and one, Regulation X, governs borrowers. Regulation T governs the amount of credit that can be ex-

\textsuperscript{51} Mr. Steak, Inc. v. River City Steak, Inc., 460 F.2d 666 (10th Cir. 1972).
\textsuperscript{52} United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975).
\textsuperscript{53} Hirsch v. duPont, 396 F. Supp. 1214 (S.D.N.Y. 1975), aff'd, 543 F.2d 750 (2d Cir. 1977).
\textsuperscript{54} 645 F.2d 404 (5th Cir. 1981).
\textsuperscript{55} General authority to issue margin regulations is found in § 7 of the Exchange Act (codified at 15 U.S.C. § 18g(a) (1976)).
\textsuperscript{56} 12 C.F.R. §§ 221.1(a), 220.3(b)(1)(i), 220.8, 207.1(c), 207.5 (1981).
tended by broker-dealers and members of national securities exchanges. Regulation U governs the amount of credit that can be extended by banks, and Regulation G governs the amount of credit that can be extended by other persons.

Regulation U only limits the amount of credit that can be extended by banks doing banking business under federal or state laws. Accordingly, it includes U.S. banks and U.S. branches of foreign banks but is not applicable to foreign branches of foreign banks.

Regulations T and G are not as specific as Regulation U in terms of their coverage of foreign and U.S. persons. As a result, foreign financial institutions have been held to be subject to Regulation T if the loan agreement is executed in the United States. Nonetheless, foreign lenders (other than U.S. branches of foreign banks) apparently are not limited by the margin regulations with respect to loans made outside the United States.

Regulation X governs persons who borrow to purchase listed or over-the-counter securities. It applies to two categories of borrowers: (1) all persons, including foreigners, who obtain credit within the United States to purchase such securities and (2) persons who borrow outside the United States for such purposes who are either (i) U.S. persons, (ii) foreign persons controlled by U.S. persons or (iii) foreign persons acting on behalf of or in conjunction with U.S. persons. As a result, Regulation X does not govern borrowings outside the U.S. by foreign persons who are acting independently and are not controlled by U.S. persons.

The result of the above rules is that many foreign persons have been able to borrow outside the United States in a manner that would violate the margin rules if the borrowers were U.S. persons or if the borrowers made their borrowings in the United States. Although perfectly legal, this type of activity arguably violates one of the purposes of the margin regulations, which is to protect the U.S. stock market from severe fluctuations caused by purchases on excessive credit.

In addition, the failure of the margin regulations to cover certain foreign transactions has been perceived as giving foreign investors an unfair advantage in tender offers for U.S. business concerns. To remedy this concern at least, legislation has been introduced in Congress which would extend the margin rules to foreign borrowers if the person ob-

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57 Id. § 220.1-.130 (1981).
58 Id. § 221.1-.123.
59 Id. § 207.1-.5.
60 Id. § 221.1-.123.
taining the credit otherwise would be required to make a filing under sections 13(d) or 14(d) of the Exchange Act in connection with the acquisition of securities financed by the credit. Accordingly, the proposed legislation would generally affect foreign borrowers who intend to acquire more than five percent of the stock of a publicly held company.

II. Currency and Asset Controls

A. General Requirements for Movements of Currency

Certain federal reporting requirements must be followed in connection with transfers of currency and monetary instruments to and from the United States. These requirements would pertain, for example, if a foreigner causes currency or monetary instruments to be sent into the United States to capitalize a U.S. business venture.

The reporting requirements are applicable to three categories of persons: (1) persons who are involved in the physical transportation of currency and monetary instruments, (2) persons who physically receive currency and monetary instruments in the United States, and (3) financial institutions. The basic requirement for persons other than financial institutions is that reports must be filed with respect to physical movements to or from the United States of currency or monetary instruments in amounts exceeding $5000. The term "monetary instruments" means U.S. and foreign currency, bearer form traveler's checks and money orders, investment securities in bearer form and bearer form negotiable instruments (except warehouse receipts and bills of lading). Thus the term would include bearer shares or bearer bonds and bank checks, and traveler's checks or money orders that have been endorsed in blank. The term, however, does not include checks made payable to a specific person but not yet endorsed, or unendorsed registered stock or bonds. Accordingly, reports do not have to be filed with respect to transactions in these types of unendorsed instruments.

The focus of the law is on the physical transportation of monetary instruments to and from the United States. A transfer of currency through bank draft, wire transfer or other written order that does not include the physical transfer of currency is not subject to these reporting requirements.

Reports relating to movements of currency or monetary instruments in excess of $5000 to or from the United States are required from persons

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66 Section 13(d) requires a report from any person who acquires securities which are of a class registered under §12 of the Exchange Act if, after the acquisition, the acquiring person owns more than 5% of the class. Section 14(d) of the Exchange Act requires filings in connection with tender offers for securities registered under §12 of the Exchange Act.
69 Id. §§103.11, 103.23.
who physically transport, mail or ship such currency or instruments or who cause such transportation, mailing or shipment. In addition, persons who receive currency or monetary instruments in excess of $5000 in the United States from sources outside this country are required to file reports if the person causing the transportation of the currency or monetary instruments has not filed a report. For example, if a foreign client brings $6000 of traveler's checks into the United States and endorses them in blank for deposit in his U.S. attorney's trust account for use in a U.S. business venture, the attorney would be required to report the transaction if the client had not filed a report upon entering the United States.

The required reports are to be filed with the U.S. Customs Service on Customs Form 4790. Travelers who are required to file the report must file it at the time of entry or departure from the United States. Shippers and mailers of currency or monetary instruments must file required reports on or before the date of mailing or shipping. Persons receiving currency or monetary instruments must file required reports within thirty days of receipt.

In addition to the reports described above, financial institutions are required to report each deposit, withdrawal, exchange of currency or other payment made by or through the institution involving more than $10,000. This requirement relates only to physical transfers of currency, and does not relate to transfers by bank check, bank draft, or wire, or to transfers of negotiable stock, bonds, or other commercial instruments. However, these reporting requirements are not limited to currency transactions or from the United States but relate both to transnational transactions and to purely domestic transactions having no relation to foreign investors. Accordingly, the main impact of these rules on foreign transactions may be simply that they create an additional level of disclosure of currency transactions in which foreigners are involved. In this regard it may be noted that financial institutions are required to file reports regarding these transactions on Form 4789 with the Internal Revenue Service.

B. Governmental Authority to Block Currency and Freeze Assets

Statutory authority to freeze assets of foreigners is found in the Trading with the Enemy Act and the International Emergency Eco-

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70 Id. § 103.23.
71 Customs Form 4790. A copy of Form 4790 appears in Appendix E to this issue.
72 31 C.F.R § 103.22 (1981).
73 Id. § 103.20.
74 Id. § 103.22.
75 Note that banks are exempt from filing reports with respect to transactions for certain types of business which normally deal with large amounts of cash. See id. § 103.22(2).
76 Id. § 103.25.
nomic Powers Act.\textsuperscript{78} Both Acts give the President of the United States authority to regulate "transactions involving any property in which any foreign country or a national thereof has any interest by a person or with respect to any property subject to the jurisdiction of the United States."\textsuperscript{79}

It should be noted that this regulatory authority extends to the interest of a foreign country as well as a foreign national, and that this authority has been exercised sometimes to affect only the interests of foreign countries and sometimes to affect the interests of both foreign countries and nationals. For example, the Iranian Assets Control Regulations, which were promulgated pursuant to the International Emergency Economic Powers Act, only blocked property of the Government of Iran, its instrumentalities and the Central Bank of Iran.\textsuperscript{80} In contrast, the Cuban Assets Control Regulations, which were promulgated pursuant to the Trading with the Enemy Act, blocked the assets of both Cuba and Cuban nationals.\textsuperscript{81}

The potential sweep of the various blocking regulations that have been promulgated pursuant to these statutes is very broad. The Cuban Assets Control Regulations control any transfer of credit through any banking institution "wheresoever located with respect to any property subject to the jurisdiction of the United States" in which Cuba, or any Cuban national has "any interest of any nature whatsoever, direct or indirect."\textsuperscript{82} Furthermore, these regulations purport to cover "all transfers outside the United States" of property subject to the jurisdiction of the United States in which Cuba or any Cuban national has any interest.\textsuperscript{83}

Thus both the enabling legislation and the various blocking regulations attempt to assert control over property "subject to the jurisdiction" of the United States. Accordingly, foreign owned bank balances in U.S. banks\textsuperscript{84} and contractual claims against U.S. persons\textsuperscript{85} have all been found to be subject to the blocking regulations. In addition, foreign owned bank balances in foreign branches of U.S. banks have been subjected to blocking regulations. Such a blocking regulation, however, might conflict with the law of the country where the U.S. bank's foreign branch is located. For example, a law of the host country may preclude banks operating in such countries from denying their customers access to deposits held by such banks.\textsuperscript{86} Obviously, such a conflict would limit the effectiveness of the blocking regulation.

\textsuperscript{79} Id. app. § 5(b)(1) (1976 & Supp. III 1979); id. § 1702 (Supp. III 1979).
\textsuperscript{80} 31 C.F.R. § 535.101-806 (1981).
\textsuperscript{81} Id. § 515.101-809.
\textsuperscript{82} Id. § 515.201.
\textsuperscript{83} Id.
\textsuperscript{84} E.g., Nielsen v. Secretary of Treasury, 424 F.2d 833 (D.C. Cir. 1970).
\textsuperscript{86} Chase Manhattan Bank v. Iran, 484 F. Supp. 832 (S.D.N.Y. 1980).
As an additional indication of which persons or property are considered to be subject to the jurisdiction of the United States for these purposes, the Cuban Assets Control Regulations provide that securities issued by U.S. persons or entities are subject to the jurisdiction of the United States and thus subject to the blocking regulation regardless of where the securities are located.\(^87\) Securities issued by foreign persons are subject to the jurisdiction of the United States if the certificate or instrument evidencing the security is located in the United States.\(^88\) The Iranian Assets Control Regulations define as a person subject to the jurisdiction of the United States "any partnership, association, corporation, or other organization wheresoever organized or doing business" which is owned or controlled by any U.S. citizen, resident, or domestic corporation, or by "any person actually within the United States."\(^89\) Because of the broad scope of these definitional rules, it may be very difficult for a foreigner to prevent freezing or blocking of assets deployed in a U.S. business.

Prior to its amendment in 1977, the Trading with the Enemy Act applied in times of war or a declared national emergency.\(^90\) The Act was amended in 1977 to limit its prospective application to only wartime situations because of a concern that no appropriate mechanism existed for terminating certain declared national emergencies.\(^91\) For example, the Cuban Assets Control Regulations were promulgated in 1969 pursuant to a national emergency declared by President Truman in 1950 in connection with the Korean War.\(^92\)

In conjunction with the amendment to the Trading with the Enemy Act, Congress enacted the National Emergencies Act\(^93\) and the International Emergency Economic Powers Act.\(^94\) As mentioned, the International Emergency Economic Powers Act gives the President powers similar to the Trading with the Enemy Act but which are to be exercisable during times of a declared national emergency as opposed to wartime.\(^95\) The National Emergencies Act provides a mechanism for automatic termination of a declared national emergency on the anniversary of its declaration unless affirmative steps are taken to prolong the emergency.\(^96\) Accordingly, future freezing orders issued in times of de-

\(^{88}\) Id.
\(^{89}\) Id. § 535.329.
\(^{92}\) 424 F.2d at 839.
\(^{94}\) Id. §§ 1701-1706 (Supp. III 1979).
\(^{95}\) Id. §§ 1701-1702.
\(^{96}\) Id. § 1622(d) (1976).
declared national emergencies may be of more limited duration than in the past.

III. Investor Anonymity

For a variety of reasons many foreign investors wish to keep the ownership and control of their business ventures confidential. This anonymity is becoming increasingly difficult to achieve with respect to investment in the United States because of the relatively recent passage of several federal laws requiring disclosure of investments by foreigners in the United States in certain circumstances. These acts are the International Investment Survey Act of 197697 (IISA), the Agricultural Foreign Investment Disclosure Act of 197898 (AFIDA), and the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).99

This article will not attempt to present a detailed description of the requirements of these acts. However, in general, IISA requires reports of investments in the United States unless the business venture has less than $1,000,000 in total assets, annual sales, gross operating revenues or post-U.S. tax income and less than 200 acres of real estate.100 AFIDA generally requires reports of foreign acquisitions of parcels of agricultural land over one acre in size,101 and FIRPTA generally requires reports of foreign ownership of U.S. real property interests having a value of $50,000 or more.102 All three acts require sufficiently detailed disclosure that in many cases will force divulgence of the ultimate beneficial owner of the investment.103

If a foreign investor is unaffected or undeterred by existing U.S. reporting requirements and still wishes to keep ownership of his U.S. investments confidential, two methods to achieve this aim are to use a form of nominee ownership or to issue the instruments evidencing ownership of the investment in bearer form.

A. Issuance of Bearer Shares by U.S. Corporations

If a foreign investor wishes to establish a U.S. corporation through which to conduct a U.S. business venture, he may encounter difficulties

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100 15 C.F.R. § 806.16 (1981).
under the relevant state corporate law if he seeks to issue the shares of that corporation in bearer form. Many states' corporate laws are silent on the issue of whether bearer shares can be issued. However, some state laws, such as those of New York and North Carolina, specify that the form of stock certificate to be issued by a corporation of that state must include the name of the person or persons to whom issued. Presumably this requirement is inconsistent with the ability to issue bearer shares, and therefore it may be assumed that bearer shares are not permitted in such jurisdictions.

Connecticut does expressly authorize the issuance of bearer shares. Connecticut law, however, does not provide any additional guidance as to how its other corporate law requirements, such as notice of shareholder meetings and its requirement to produce stockholder lists, are to be observed when bearer shares are issued. This raises the general question of how such corporate formalities, as well as the formalities relating to stockholder votes and payments of dividends, are to be addressed in a bearer share situation.

Despite their wide use elsewhere, bearer shares are relatively unknown in the United States. Accordingly, there is little judicial or statutory guidance as to what type of mechanical solutions can be devised to provide for the corporate and stockholder formalities. In structuring such solutions, it is important not only to ensure that the foreign investor can adequately exercise his stockholder rights but also to protect the corporation in acts it may take in paying dividends or acting pursuant to votes of purported stockholders.

While U.S. law provides little guidance as to a proper way to resolve these types of mechanical problems when dealing with bearer shares, useful models do exist under the laws of other jurisdictions. For example, bearer shares often are issued with dividend coupons attached. The corporation’s bylaws then provide that it will not be liable for payment of a dividend to an unauthorized person if it makes payment against tender of the coupon. Similarly, to solve the issue of who is entitled to vote, a “deposit” system sometimes is created whereby holders of the bearer shares deposit them with a bank or other designated agent who then votes the shares in accordance with the holder’s instructions but without revealing the identity of the beneficial owner. Despite these useful precedents under the laws of other jurisdictions, it seems unlikely that

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108 Id. at 524.
109 Id. at 524-25.
bearer shares will be of much use to foreign investors in U.S. corporations because of the limited number of states in which their issuance is or might be valid.

B. Nominee Ownership

As opposed to the bearer form of ownership discussed above, the issuance of corporate shares in nominee name is a widely followed method of attaining investor anonymity in the United States. Because many state statutes permit a corporation to treat its registered stockholders as stockholders for all purposes, nominee ownership does not raise the same type of problems in corporate formalities described above. In addition, with respect to the ownership of certain assets such as real estate, where the bearer form of ownership is impossible, nominee ownership may represent the only practical method of attempting to achieve investor anonymity.

Nominee ownership, however, may present severe tax risks if used improperly. The basic problem is that the nominal owner, as opposed to the beneficial owner, may be treated as the owner of the asset for tax purposes. For example, if real estate is owned by a nominee corporation, the net income from the real estate could be taxed to the corporation and not to the beneficial owner for whom the nominee corporation was acting. In addition, if real estate is transferred to a nominee corporation by a beneficial owner, the capital gains holding period of the beneficial owner and the “first user” depreciation status of the real estate may be lost.

While the following discussion will focus on the risk of using nominee corporations (sometimes called “straw” or “dummy” corporations), it arguably is applicable as well to the use of “straw” men, or nominee or “straw” partnerships, where the person or partnership used is separate from the beneficial owner of the property held in nominee name.

In determining whether nominee corporations should be taxed on the income from properties held by them, the courts have followed two basic theories. Under the “disregard” theory, the argument is that a shareholder and his wholly owned corporation should be treated for tax purposes as a single entity, at least in some circumstances. Accordingly, the separate existence of the corporation should be disregarded for all tax purposes.

The “disregard” theory appears to have been stripped of most of its vitality by the Supreme Court’s decision in Moline Properties, Inc. v. Com-

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112 Miller, supra note 110.
113 I.R.C. §§ 1223(2), 167(c) (1976).
114 Miller, supra note 110, at 243; see also Love v. United States, 96 F. Supp. 919 (Ct. Cl. 1951).
missioner. Moline is widely believed to stand for the proposition that so long as the nominee corporation serves any business purpose or conducts any business activity, its existence as a separate taxable entity cannot be disregarded. Thus, it appears that if a foreign investor wishes to place title to his assets in the name of a nominee corporation, he will be unsuccessful in claiming that the existence of the corporation should be disregarded for tax purposes if there is any business purpose for the manner in which title is held. Obviously this leaves some room for argument as to what constitutes a business purpose or business activity. In this regard, the use of a nominee corporation to avoid state usury laws has been held to be a business purpose, but the use of such a corporation to avoid taxes or deter creditors may not be a business purpose.

The "agency" theory provides an alternative to the "disregard" theory in dealing with the issue of the taxability of nominee corporations. Under the agency theory, the taxpayer admits that the nominee corporation exists for tax purposes. He argues, however, that the nominee corporation is acting only as an agent or nominee in holding title to the property for the real owner and thus should not be taxed upon any income from the property. In determining whether a true corporate agency exists for these purposes, courts have analyzed the relevant facts with reference to six tests set forth in the Supreme Court's opinion in National Carbide Corp. v. Commissioner. These tests are (1) whether the nominee corporation operates in the name of and for the account of its principal; (2) whether the acts of the nominee corporation bind its principal; (3) whether the nominee corporation transmits money received by it to its principal; (4) whether the income of the nominee corporation is attributable to the employees, assets or services of its principal; (5) whether the nominee corporation's relationship with its principal is based upon ownership of the nominee corporation by its principal; and (6) whether the nominee corporation's actions are consistent with the normal duties of an agent.

Until the recent case of Roccaforte v. Commissioner, taxpayers had been notably unsuccessful in attempting to apply the agency theory. Roccaforte, however, found a true corporate agency to exist in the case of a nominee corporation established to avoid state usury law restrictions and permitted the income from the property in question to be taxed to the

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115 319 U.S. 436 (1943).
116 Miller, supra note 110, at 236.
118 Miller, supra note 110, at 229 n.35; Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945).
120 336 U.S. 422 (1949).
121 Id. at 437.
beneficial owners of the property and not to the corporation.\textsuperscript{123}

In reaching its decision, the Tax Court made two conclusions that may be of interest to foreign investors seeking to avail themselves of the agency theory so that a nominee corporation will not be taxed on the income from the assets it holds. First, the court in \textit{Roccaforte} found that the nominee corporation's relationship with its principal was based on ownership of the corporation by the principal. Therefore, the nominee corporation in \textit{Roccaforte} failed this aspect of the \textit{National Carbide} test because, under \textit{National Carbide}, if a corporation is a true agent its relations with its principal must not be dependent upon the fact that it is owned by its principal.\textsuperscript{124} Accordingly, to ensure satisfaction of this test, it clearly is advisable that the nominee corporation be owned by persons other than the beneficial owners of the property involved. This division of ownership may prove unpalatable to many foreign investors.

Second, the \textit{Roccaforte} court stated that \textit{National Carbide} requires that a nominee corporation's activities be consistent with the duties of a true corporate agent.\textsuperscript{125} The court found it compelling that the nominee corporation acted as an agent with a disclosed principal. In this regard, the court noted that the investors in \textit{Roccaforte} represented to the nominee corporation's creditors that they, and not the corporation, were the true obligors of the debt assumed by the nominee corporation.\textsuperscript{126} If foreign investors wish to use nominee corporations to preserve their anonymity, they would wish nominee corporations to act as agents with undisclosed principals.\textsuperscript{127} These circumstances would increase the risk that the \textit{Roccaforte} holding would not be applicable and that a nominee corporation would be found to be not a "true corporate agent"\textsuperscript{128} for tax purposes.

In summary, if foreign investors wish to use nominee corporations for business purposes, it is unlikely that the existence of such corporations will be disregarded for tax purposes. Furthermore, if the foreign investors have ownership control of such nominee corporations or if the corporations act as agents for such investors but do not disclose the identity of their principals, there may be a significant risk that the corporations will not be regarded as agents for tax purposes and that the corporations will be subject to tax on any income earned on assets held in nominee ownership.

\textsuperscript{123} Id. at 287.
\textsuperscript{124} 336 U.S. at 437.
\textsuperscript{125} 77 T.C. at 287.
\textsuperscript{126} Id.
\textsuperscript{127} See Restatement (Second) of Agency § 4(3) (1958).
\textsuperscript{128} 336 U.S. at 437.
IV. Taxation

A. Summary of U.S. Federal Income Taxation of Nonresident Alien Individuals and Foreign Corporations

The manner in which the United States taxes foreign investors is probably the most crucial element in structuring any U.S. business enterprise or investment made by such persons. In general, the United States taxes only the U.S. source income of foreign persons. This U.S. source income is taxed in two different ways:

1. If the foreign person is engaged in a trade or business in the United States, the United States taxes the amount of his net income that is effectively connected with that business at the same progressive rates which are applicable to U.S. citizens and corporations.

2. U.S. source income of foreign persons which is not effectively connected with a U.S. trade or business of the foreign person is taxed as follows:

   a) Income of a fixed and repetitive nature such as dividends and interest is taxed at the flat rate of thirty percent, and no deductions are allowed in computing the tax. This tax will hereafter be referred to as the "thirty percent tax."

   b) A foreign corporation's capital gains which are not related to real estate are not taxed. A nonresident alien individual's net capital gains which are not related to real estate are not taxed unless the individual is present in the United States for 183 days or more during the year, in which case the net gains are taxed at thirty percent.

   c) Capital gains of foreign individuals and corporations derived from U.S. real estate are taxed regardless of whether such gains are re-
lated to a U.S. business. In general, such gains are taxed at capital gains rates with a minimum tax of twenty percent for individuals and twenty-eight percent for corporations.

(d) No other non-business related income of foreign persons is taxed.

The tax treaties between the United States and foreign countries can vary the results set forth above for those foreign taxpayers eligible to benefit from the particular treaty. For example, most treaties reduce the rate of U.S. tax on non-business related dividends and interest from thirty percent to fifteen percent or less. Most treaties also provide that U.S. source commercial and industrial (i.e. business) profits of foreign persons are not subject to tax unless the foreigner maintains a "permanent establishment" in the United States to which the profits are attributable. A permanent establishment is defined in the U.S. Model Income Tax Treaty as a "fixed place of business through which the business of an enterprise is wholly or partly carried on." It includes a branch, office, factory, workshop, mine, or oil or gas well. As a result of these treaty rules, if a foreigner is eligible for treaty benefits, and can conduct business in the United States without having a permanent establishment, he will avoid U.S. tax on income that is effectively connected to that business.

Many foreigners are either not eligible for treaty benefits or cannot conduct a U.S. business without creating a permanent establishment. As a result, their profits from active business ventures are subject to full U.S. taxation. In addition, if foreign investors conduct their U.S. business ventures through U.S. corporations, they can be subject to the so-called "double tax," that is, one tax at normal corporate rates to the corporation on its business income and one tax at a flat thirty percent rate to the foreign shareholder, when the U.S. corporation pays out its after-tax profits to the shareholder by way of dividends. This double tax can exist even if the foreign investor conducts his U.S. business venture through a foreign corporation, because in certain circumstances foreign

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136 Id. § 897(a)(1) (West Supp. 1982).
137 Id. §§ 897(a)(2), 1201(a)(2) (West Supp. 1982).
138 See id. §§ 871(a)(1), 881(a).
140 Treasury Department's Model Income Tax Treaty, June 16, 1981, art. 5, reprinted in 1 Tax Treaties (CCH) § 158. For more discussion on the concept of "permanent establishment" in tax treaties, see Ruchelman, supra note 102, at 203-04.
141 Cf. I.R.C. § 894(a) (1976) (nonresident alien individual or foreign corporation is deemed not to have a permanent establishment in the United States at any time during the taxable year with respect to income not effectively connected with conduct of U.S. trade or business).
142 See generally 1 F. O'Neal, Close Corporations §§ 1.09, 2.04 (2d ed. 1971), for a discussion of "double taxation" and how to avoid it.
143 Id.
corporations can both be subject to tax on their “effectively connected” U.S. income and pay dividends which are considered “U.S. source” and thus subject to the thirty percent tax if paid to a foreign shareholder.\textsuperscript{144}

A standard technique to attempt to minimize the above described double tax on a corporation and its shareholder is for the shareholder to capitalize the corporation with a substantial amount of debt. Interest on the debt will be a deductible expense to the corporation,\textsuperscript{145} and thus any interest paid by a corporation to a shareholder-creditor on account of his debt will escape U.S. tax at the corporate level. In addition, if the interest is not “U.S. source” it will not be subject to the thirty percent tax when paid to the foreign shareholder-creditor.\textsuperscript{146}

Similar techniques to avoid the double tax on corporate profits can be used with payments of rent, salaries, royalties and other items which are deductible to the corporation. In all cases, however, the thirty percent tax will be due on any such items that are U.S. source.

\textbf{B. U.S. Source Income}

\textit{(1) Interest.} With several notable exceptions, the definition of U.S. source interest includes interest paid by (a) the United States, a state, or a federal or state governmental agency, (b) a U.S. resident individual, (c) a domestic corporation, (d) a domestic or foreign partnership which is engaged in a U.S. trade or business and (e) a foreign corporation which is engaged in a U.S. trade or business.\textsuperscript{147} The place of payment is immaterial.\textsuperscript{148}

There are several important exceptions to this definition of U.S. source interest. For example, interest paid by a resident alien individual or domestic corporation is not U.S. source interest if less than twenty percent of the gross income from all sources of the individual or corporation during the three year period ending with the year preceding the year the interest is paid or credited is derived from sources within the United States.\textsuperscript{149} Also, interest paid by a foreign corporation is U.S. source interest only if fifty percent or more of the foreign corporation’s income from all sources during a similar three year period is “effectively connected” with a U.S. trade or business. If fifty percent or more of a foreign corporation’s income is effectively connected income, a portion of the interest paid by the foreign corporation will be treated as U.S. source. This por-

\textsuperscript{145} Id. § 163 (1976). Note that interest will be deductible to a foreign corporation only to the extent that it is “effectively connected” income. Id. § 873(a) (1976). See also the proposed debt/equity ratio regulations, 47 Fed. Reg. 164 (1982) (to be codified in 26 C.F.R. §§ 1, 15A).
\textsuperscript{146} Non-U.S. source income is not subject to U.S. tax under I.R.C. § 871 (West & West Supp. 1982). A nonresident alien individual could, however, be subject to tax at the rates applicable to U.S. citizens under id. § 871(b) (West Supp. 1982) if the interest is considered “effectively connected” income.
\textsuperscript{147} Id. § 861(a) (West & West Supp. 1982).
\textsuperscript{149} Id. § 1.861-2(b)(2) (1975).
tion is based on the ratio of the foreign corporation's effectively connected income to its total income.¹⁵⁰ Notwithstanding the fact that a foreign corporation has been engaged in a U.S. business and satisfies the fifty percent effectively connected income test, if the foreign corporation is not engaged in a U.S. trade or business when the interest is paid or credited, the interest will not be U.S. source.¹⁵¹ It should be noted that interest includes unstated interest under I.R.C. section 483 and original issue discount under I.R.C. section 1232(b)(1).¹⁵²

(2) Dividends. The sourcing rules relating to dividends are similar but not identical to the sourcing rules relating to interest. For example, dividends paid by domestic corporations are U.S. source unless less than twenty percent of the corporation's gross income from all sources during the three years preceding the year when the dividend is declared is U.S. source income.¹⁵³ Dividends from foreign corporations are not U.S. source if less than fifty percent of the foreign corporation's gross income for a similar three year period is effectively connected to a U.S. business. If fifty percent or more of the foreign corporation's gross income during such period is effectively connected, a portion of the dividends declared by it will be U.S. source. Again, this portion is based on the ratio of the foreign corporation's effectively connected income to its total income.¹⁵⁴ Unlike the case of U.S. source interest, the foreign corporation does not have to be engaged in a trade or business in the United States in the year the dividend is declared in order for the dividend to be U.S. source.¹⁵⁵ Dividends from possessions, corporations and Domestic International Sales Corporations are not U.S. source.¹⁵⁶

(3) Rental, Royalties and Compensation. In general, the source of rental and royalty income is the place where the property is used.¹⁵⁷ The place or identity of the payor is immaterial to the determination of the source of the rental or royalty. For example, royalties paid by a Netherlands corporation to a third country person for the use of U.S. rights to a patent are U.S. source, even where the Netherlands corporation sublicenses the patent rights to a U.S. corporation that actually uses the rights in the United States.¹⁵⁸ Compensation for services performed in this country is U.S. source income, while compensation for services per-

¹⁵⁰ Id. § 1.861-2(b)(3) (1975).
¹⁵¹ Id.
¹⁵² Id. § 1.861-2(a)(4) (1975).
¹⁵⁴ Id. § 861(a)(2)(B) (1976).
formed outside of the United States is not.\textsuperscript{159} Excluded from this definition are nonresident aliens who are temporarily in the United States for no more than ninety days, who earn no more than $3000 during the year, and who are employees of foreign individuals, partnerships or corporations not engaged in a trade or business in the United States or of a foreign office of a U.S. business.\textsuperscript{160}

C. Withholding

The thirty percent collected by withholding\textsuperscript{161} arises only with respect to U.S. source dividends, interest, rents and similar items of "fixed or determinable annual or periodic income" which are not effectively connected to a U.S. trade or business.\textsuperscript{162} If a foreign taxpayer receives items of such income that are effectively connected to a U.S. trade or business, the thirty percent tax will not apply, no withholding will be required, and the items will be subject to tax at rates applicable to U.S. citizens, residents or corporations.\textsuperscript{163}

It should be noted that the thirty percent tax applies to the gross amount of the item paid, and that no deductions are allowed in computing the tax. For example, if a foreigner owns a residence in the United States which he rents for $10,000 per year and with respect to which he pays $8000 per year in mortgage interest and real estate taxes, his tenant could be obligated to withhold $3000 per year on account of the thirty percent tax notwithstanding the fact that this will result in a $1000 per year loss to the foreigner on account of the transaction ($10,000 less 8000 less 3000).\textsuperscript{164}

The obligation to withhold does not arise until the time of payment to the owner of the income or until disposal for the owner's account.\textsuperscript{165} The person required to withhold is the person having control, receipt, custody or disposal of the funds.\textsuperscript{166} This person, the "withholding agent," is personally liable for the tax. If the tax is paid by the recipient of the income, however, the agent's liability is relieved.\textsuperscript{167}

If the withholding agent fails to withhold when making a payment to a foreigner, and is subsequently required to pay the tax, he may be unable to recover the underwithheld amount from the foreign recipient. As indicated in the only decided case on the issue, this harsh result may stem from a feeling that the withholding agent's liability for underwithholding is in the nature of a penalty.\textsuperscript{168} Despite this decision, if a

\textsuperscript{159} I.R.C. § 861(a)(3) (1976).
\textsuperscript{160} Id.
\textsuperscript{161} Id. §§ 1441, 1442 (1976).
\textsuperscript{162} Id. § 1441(a), (c)(1).
\textsuperscript{163} Id. §§ 871(b), 882 (West & West Supp. 1982).
\textsuperscript{164} Rev. Rul. 75-23, 1973-1 C.B. 290.
\textsuperscript{166} I.R.C. § 1441(a) (1976).
\textsuperscript{167} Id. § 1463 (1976).
\textsuperscript{168} Synthetic Patents Co. v. Sutherland, 22 F.2d 491 (2d Cir. 1927).
withholding agent is found personally liable for underpayment, he may be able to offset his liability against other property of the owner in the agent's possession.\textsuperscript{169}

\textbf{D. Treaty Variations}\textsuperscript{170}

As mentioned above, the pattern of U.S. federal income tax on non-resident aliens and foreign corporations can be modified by treaty.\textsuperscript{171} This article already has discussed the manner in which many treaties eliminate the tax on commercial and industrial profits from foreign business enterprises conducted in the United States if no permanent establishment is present.\textsuperscript{172} Treaty rules also can have a significant effect on the imposition of the thirty percent tax. This may be accomplished by changing the source rules, by exempting from tax dividends and interest paid by foreign corporations, and by reducing or eliminating the thirty percent tax.

\textbf{(1) Changing Source Rules.} The tax treaty between the United States and France changes the source rules for dividends so that dividends paid by a French corporation cannot be U.S. source unless the French corporation maintains a permanent establishment in the United States and eighty percent of its gross income of the three year period prior to the year of declaration of the dividend is "taxable to" the permanent establishment.\textsuperscript{173} Accordingly, this treaty changes the normal rule set forth above that classifies a portion of a foreign corporation's dividend as U.S. source if fifty percent or more of its income is "effectively connected with the conduct of a trade or business within the United States" within a similar three year period.\textsuperscript{174}

\textbf{(2) Exemption from U.S. Tax of U.S. Source Dividends and Interest Paid by Foreign Corporations.} Several U.S. treaties exempt from withholding tax any dividends or interest paid to a foreign person by a foreign corporation, even though such dividends or interest would normally be treated as U.S. source. For example, Article IV(2) of the Australian treaty exempts from tax a U.S. source dividend paid to an Australian resident by a company resident in Australia.\textsuperscript{175} Article XII of the Netherlands treaty exempts from U.S. tax U.S. source dividends and interest paid by a Netherlands corporation except where the recipient is a citizen, resi-

\textsuperscript{169} McGrath v. Dravo, 183 F.2d 709 (3d Cir. 1950).
\textsuperscript{170} As a supplement to the discussion that follows in the text, see Ruchelman, supra note 102, at 201-05.
\textsuperscript{171} I.R.C. § 894(a) (1976).
\textsuperscript{172} See supra text accompanying notes 138, 139.
\textsuperscript{174} See supra note 153.
dent or corporation of the United States.\textsuperscript{176} A similar provision exists in the treaty with the Netherlands Antilles.\textsuperscript{177} Because the Netherlands Antilles treaty does not require the recipient of the dividend to be a resident of the Netherlands Antilles to gain the benefit of this provision, and because of certain low tax benefits available there, the Netherlands Antilles has become a favored jurisdiction for foreign investors seeking treaty benefits.

Article 10(5) of the U.S. Model Treaty would exempt from U.S. tax a U.S. source dividend paid by a foreign corporation except for (a) a dividend paid to a United States resident, (b) a dividend paid with respect to a stock holding that is effectively connected to a permanent establishment in the U.S., or (c) a dividend from a foreign corporation fifty percent or more of whose gross income from all sources for the three years prior to the year the dividend is declared is effectively connected income \textit{and} is "attributable" to a permanent establishment in the United States.\textsuperscript{178} It should be noted that by requiring a connection to a permanent establishment, this last exception is more limited than the general rule regarding U.S. source dividends of foreign corporations. As noted, all that is required to be subject to tax under the general rule is that fifty percent or more of the gross income be effectively connected to a U.S. trade or business,\textsuperscript{179} with no requirement that the effectively connected income be "attributable" to a permanent establishment.

Because the Model Treaty represents the negotiating position of the United States in treaty discussions, it can be expected that the United States will attempt to include a similar provision in new treaties and in any existing treaties that it renegotiates.

\textbf{(3) Reduction and Exemption from Thirty Percent Rate.} As mentioned, many treaties reduce or eliminate the thirty percent tax on dividends or interest. These reductions or exemptions may be contrasted with those discussed immediately above in that they apply to all U.S. source dividends and interest and not just to those paid by a foreign corporation. In addition, the focus of this exemption is whether the U.S. source dividend is paid to a person eligible for treaty benefits and not whether the U.S. source dividend or interest is paid by such a person. For example, the U.S. treaty with the United Kingdom exempts U.S. source interest from the thirty percent tax.\textsuperscript{180} Accordingly, U.S. source interest paid by a Delaware corporation, a U.K. corporation or a corporation organized anywhere else in the world would be exempt from the thirty percent tax

\begin{enumerate}
\item \textsuperscript{176} Netherlands Treaty, supra note 139, art. XII.
\item \textsuperscript{177} Protocol Extending Income Tax Treaty, June 15, 1955, United States-Netherlands Antilles, art. XII, 6 U.S.T. 3696, T.I.A.S. No. 3366.
\item \textsuperscript{178} Treasury Department’s Model Income Tax Treaty, May 17, 1977, art. X, para. 5, 1 Tax Treaties (CCH) ¶ 153.
\item \textsuperscript{179} I.R.C. § 861(a)(2) (West & West Supp. 1982).
\item \textsuperscript{180} United Kingdom Treaty, supra note 139, art. 11.
\end{enumerate}
if received by an investor eligible for the benefits of the U.S.-U.K. treaty. A U.S. source dividend paid by a U.K. corporation to a person not eligible for treaty benefits, however, would be subject to the thirty percent tax because the U.S.-U.K. treaty does not contain a provision similar to Article XII of the Netherlands Treaty\textsuperscript{181} exempting from the thirty percent tax all U.S. source interest paid by a Netherlands corporation to non-U.S. persons.

With respect to the reductions and exemptions covered by this type of treaty provision, the U.S. position, as reflected in the U.S. Model Income Tax Treaty, is that "the rate of tax on dividends should be reduced to five percent in the case of a direct investment (ownership of ten percent or more of the stock of payor corporation) and to fifteen percent in the case of portfolio investment. Interest and royalties should be exempt from tax at source."\textsuperscript{182}

The reduced rates of withholding generally are available only to residents of the treaty state.\textsuperscript{183} In addition, to prevent treaty shopping, certain U.S. treaties specify that reduced withholding rates are not available to companies that enjoy special tax benefits in their home countries. For example, the September 28, 1964, protocol modifying the Netherlands Antilles Treaty indicates that the reduced rates of withholding tax on U.S. source dividends, interest, and royalties provided for by the treaty will not be extended to holding companies entitled to special, low tax treatment in the Netherlands Antilles.\textsuperscript{184} Article 16 of the U.S. Model Treaty in essence provides that if twenty-five percent or more of the stock of a corporation of the foreign contracting state is owned by nonresidents of that contracting state, and if the corporation is entitled to special low tax benefits under the laws of its jurisdiction, the reduced rates of tax on U.S. source dividends, interest, and royalties provided by the Model Treaty will not be applicable.\textsuperscript{185} Accordingly, it can be expected that the United States will press for this provision in new or amended treaties.

E. Patterns of Treaty Use

Foreign investors have evolved several well known patterns of structuring business ventures in the United States to take maximum advantage of the aforementioned treaty rules. An outline of some of these patterns follows.

(1) Active Business by U.S. Enterprise: Back to Back Loans. If a foreign

\textsuperscript{181} See supra text accompanying note 176.
\textsuperscript{182} Gordon, Tax Havens and Their Use by United States Taxpayers—An Overview (1981).
\textsuperscript{185} Treasury Department's Model Income Tax Treaty, 1 Tax Treaties (CCH) ¶ 158.
taxpayer utilizes a U.S. corporation to transact business within the United States, it will be advantageous for the corporation to be capitalized with debt so that the interest deductions can offset the corporation's taxable income. U.S. source interest paid by the U.S. corporation to the foreign creditor will be subject to the thirty percent withholding tax unless a treaty reduction is available. To attempt to minimize the thirty percent tax the foreign investor would establish a corporation (the "finance corporation") in a country with a favorable treaty with the United States. The investor would then make a loan to the finance corporation which would reloan the sum to the U.S. corporation. A schematic representation of this transaction, with indicated results, is as follows:

```
A
No-Treaty Owner

Interest on loan from A to B not subject to withholding because not U.S. source (B's interest income not effectively connected)

B
Treaty Country Finance Company

Interest on loan from B to C entitled to reduced withholding because of treaty

C
U.S. Corporation Conducting Business Enterprise
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This type of transaction runs a severe risk of disallowance if it falls within the scope of *Aiken Industries, Inc.* 186 *Aiken Industries* involved a set of facts very similar to the schematic set forth above. In addition, in *Aiken* the interest payable by the U.S. corporation on its loan from the finance corporation was identical to the interest payable by the finance corporation to its shareholder. The court found that the transaction was a sham and that the interest payable by the U.S. corporation to the finance corporation was not entitled to treaty benefits. To support this finding the court said that the matched inflow and outflow of funds to the finance corporation indicated that the actual recipient of the interest payment was not the finance corporation but its owner. Because the owner was not entitled to treaty benefits, the benefits were denied. Obviously, if a "back to back" arrangement is to be put in place successfully,

186 56 T.C. 925 (1971).
greater economic substance must be given to the transactions than that provided in the *Aiken* case.

(2) *Active Business by Foreign Corporation-Finance Company.* The *Aiken Industries* risk can be eliminated by arranging for a foreign treaty country corporation to conduct business in the United States instead of having that business conducted by a U.S. corporation. A schematic representation of this structure is as follows:

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A
No-Treaty Owner

B
Offshore Finance
Company

Loan

C
Treaty Country
Corporation
Conducting U.S.
Business
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Interest or dividends from B to A are not U.S. source, therefore no withholding

Interest from C to B may be U.S. source but can be exempt from withholding under certain treaties, e.g., Art. XII of Netherlands Antilles Treaty, without B being a corporation residing in the Treaty Country.

It should be noted that in the absence of certain treaties, as noted in the diagram, it is imperative in this case that interest payments made by the foreign corporation engaged in business in the United States (for example, C to B) be considered not U.S. source. If any such payments are U.S. source, they would be subject to the thirty percent tax which would defeat the purpose of the structure. Again, if fifty percent or more of a foreign corporation's income for a specified period is effectively connected with a U.S. business, interest that it pays can be U.S. source. If it will be impossible to avoid U.S. source interest because of this rule, the foreign corporation conducting business in the United States will have to be formed in a jurisdiction, such as the Netherlands Antilles, that has a treaty exempting U.S. source interest paid by such corporations from the thirty percent tax.

(3) *Patent Income—Back to Back Arrangements.* In theory at least, the *Aiken Industries* risk in back to back arrangements also can be avoided by creating a mixture of payments of interest, dividends, and royalties. For example, if a non-treaty foreigner owns rights for use of a patent in the United States, he could structure the following transaction:

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188 Income Tax Treaty, April 29, 1948, United States-Netherlands Antilles Treaty, art. XII.
There are several additional tax considerations that may be of considerable importance in structuring the financing of a foreign business enterprise or investment in the United States. For example, a nonresident alien individual (NRA) is subject to U.S. estate tax in certain circumstances and this fact may alter the manner in which U.S. investments should be held.

The gross estate of an NRA for U.S. estate tax purposes includes any property situated in the United States. This includes stock of domestic corporations and debt obligations of U.S. persons regardless of where such stock or debt is held. U.S. real estate is also property situated within the United States. Stock and debt of foreign issuers is not subject to U.S. estate tax even if held in the United States. As a result, a foreign individual with considerable holdings of U.S. securities or real estate may wish to hold his investments through an offshore corporation so that U.S. estate tax will not be due with respect to these investments.

In addition to estate tax issues, if a foreign investor utilizes a foreign entity in connection with an investment in the United States, it is important that the entity be classified correctly for U.S. tax purposes. Obvi-

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190 Netherlands Treaty, supra note 176, art. IX.
191 I.R.C. § 2101 (1976). The value of the gross estate of a nonresident alien is limited to property situated within the United States. Id. § 2103 (1976).
195 See id. § 20.2105-1, 26 C.F.R. § 20.2105-1.
ously the tax consequences of discovering that a foreign operation will be treated as a partnership rather than as a corporation for tax purposes, or vice versa, can have a material impact on the tax consequences of a particular structure.

At the moment there is considerable uncertainty as to the proper classification of foreign entities for tax purposes and the manner in which such classification should be approached. At one point it appeared that a juridical entity, created as such under foreign law, would be regarded as a corporation for U.S. tax purposes without regard to whether it qualified under the standards of I.R.C. section 7701 and the regulations thereunder. In September 1976 the IRS issued its Guidelines on Foreign Forms of Business Organization which lists nearly 200 forms of business organizations and classifies many of them as a corporation or partnership. The guidelines indicate, however, that proper classification will be dependent upon the facts and circumstances of each case and will then be subject to the tests of the regulations under I.R.C. section 7701. The IRS subsequently published Revenue Ruling 77-214, which appears to have added an additional factor to the normal tests under the section 7701 regulations for purposes of the classification of a foreign entity. As a result, the law in this area is unclear, and apparently the safest course would be to follow the existing regulations under section 7701 in determining the classification of foreign entities.

V. Conclusion

As noted, there are many aspects of the law relating to foreign investment in the United States that are not well settled. In addition, it seems likely that significant new issues will arise in the future. As a result, representing foreign investors is far from routine, and both experienced and inexperienced counsel can expect continuing challenges and opportunities to develop expertise in new areas of the law.

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198 Guidelines on Foreign Forms of Business Organization, 1 Internal Revenue Manual (CCH) ch. 673, at 7283-72.