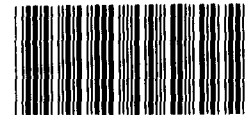


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STATEMENT OF
WILLIAM J. ANDERSON, DIRECTOR
GENERAL GOVERNMENT DIVISION
BEFORE THE
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
ON
LEGISLATIVE PROPOSALS TO
REVISE THE 30-PERCENT
WITHHOLDING TAX ON U.S.-SOURCE
INTEREST INCOME PAID
TO FOREIGN PERSONS



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Mr. Chairman and Members of the Committee:

We are pleased to be here to assist the Committee in its deliberations over proposed revisions to the statutory 30-percent withholding tax on U.S.-source interest income paid to foreigners. Our testimony is based on work we have done during the past 2 years on several international tax issues. In particular, we have analyzed the potential for abuse of the U.S.-Netherlands Antilles tax treaty, and we have compared the U.S. withholding tax system to the systems operated by several other countries.

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In so doing, we gathered and analyzed data on U.S.-source income paid to foreign investors and information on the U.S. withholding tax on that income. We have also discussed the issue of U.S. corporate access to the Eurobond market with officials from the Departments of the Treasury and State, the Internal Revenue Service (IRS), and representatives of the securities industry.

As you know, Mr. Chairman, the U.S. generally imposes a statutory 30-percent tax on various types of income such as interest, dividends, rents, and royalties paid to foreign investors. The tax is withheld at source by withholding agents such as banks, brokerage firms, and corporations. However, the tax may be reduced or eliminated if the income recipient claims residence in a country which has a tax treaty with the United States.

Through our work, we identified three factors which the Committee needs to consider in its deliberations over the U.S. 30-percent withholding tax:

- First, U.S. corporations make extensive use of the Eurobond market to finance their business operations. As a practical matter, current U.S. corporate access to the Eurobond market depends entirely on the unique relationship between the existing U.S. tax treaty with the Netherlands Antilles and the domestic laws of that country.
- Second, offshore financial activities have grown in their importance to the economy of the Netherlands Antilles. That growth occurred to some extent with the actual or tacit approval of the U.S. government.
- And third, the U.S. tax treaty with the Netherlands Antilles has been subject to abuse by third-country persons and perhaps by U.S. citizens. For several years now, Treasury has been trying to renegotiate the treaty to prevent such abuses. However, negotiations have not yet proven successful.

In part because Treasury has found it difficult to reach agreement with the Netherlands Antilles on a new tax treaty, the Congress is now in the position of having to make a difficult decision which may have far-reaching effects. In our view, the Committee has at least five potential alternatives from which to choose, ranging from seeking to maintain the status quo to immediate repeal of the 30-percent withholding tax. Before elaborating on each alternative, I would like to provide the Committee with some background information.

U.S. CORPORATIONS MAKE EXTENSIVE
USE OF THE EUROBOND MARKET

Over the past several years, U.S. corporations have frequently turned to the Eurobond market to borrow funds. This is because the market has represented a large pool of available funds which sometimes can be borrowed at rates lower than those available in the U.S. According to securities industry representatives, when U.S. corporations take advantage of the Eurobond market, they generally pay about one-half of one percent less in interest charges than would be the case in the domestic U.S. bond market.

According to securities industry data, U.S. corporate reliance on the Eurobond market as a source of long-term debt financing increased steadily from 1974 to 1982, declining somewhat in 1983. During calendar years 1980 through 1983, the Eurobond market was the source for about 15 percent of the funds raised through bond issues by U.S. corporations. In its peak year--1982--the \$14.6 billion borrowed on the Eurobond market by

U.S. corporations represented 28 percent of the \$52.1 billion in total domestic and foreign bond offerings by U.S. corporations.

Thus, the Eurobond market has become an important source of capital for U.S. corporations. And the Chairman of the Federal Reserve, in testimony before the House Committee on Banking, Finance and Urban Affairs in February 1984, said that most forecasts suggest that the U.S. will have to borrow extensively abroad this year to meet projected funding needs. Eurobonds, of course, need supply only a portion of these funds because foreign investment also can enter the U.S. in other ways, such as through bank deposits and purchases of Treasury securities by certain parties. Generally, these types of foreign investments already are, by law, exempt from U.S. withholding tax. Nevertheless, Eurobonds are expected to serve as a major source of funds for U.S. corporations this year.

Given that, Mr. Chairman, I think it would be helpful to briefly discuss how U.S. corporations now gain access to the Eurobond market through the Netherlands Antilles.

GROWTH OF NETHERLANDS ANTILLES
OFFSHORE FINANCIAL ACTIVITIES

In 1955, the United States' tax treaty with the Netherlands was extended to the Netherlands Antilles, a country composed of six islands in the Caribbean. Subsequently, the Netherlands Antilles amended its internal law so as to encourage third-country persons to invest money through the Antilles.

At that time, as compared to the present, there was only limited U.S. corporate activity in the form of international

borrowing. But corporations nonetheless desired to develop a means for gaining access to foreign capital at costs which sometimes could be lower than those paid for U.S.-source borrowings. During the early 1960's, the U.S. government decided that providing for such access would be in the best interests of the nation's economy.

Accordingly, IRS began issuing private letter rulings to corporations stating that, under certain conditions, the U.S. statutory 30-percent withholding tax would not apply to Eurobond borrowings by offshore finance subsidiaries of U.S. corporations. Specifically, IRS ruled that the negotiated tax treaty rate of zero would apply to interest payments between the two countries. Because Antilles law placed only a small domestic tax on the activities of finance subsidiaries, that country became the most popular base for such entities.

The popularity of finance subsidiaries declined somewhat in 1971, however, with the U.S. decision to abandon fixed exchange rates. And questions arose as to the need for an exemption from the 30-percent withholding tax for corporate overseas borrowings. IRS decided at that point to cease issuing private letter rulings exempting overseas borrowings from the tax and, as a result, the popularity of such borrowings declined.

In 1974, however, a U.S. law firm issued an opinion which held that the U.S. 30-percent withholding tax did not apply to certain forms of overseas borrowings. IRS did not challenge that legal opinion and, subsequently, the process of obtaining a similar legal opinion for each overseas offering became standard practice among corporate borrowers.

At this point, Mr. Chairman, it might be helpful to describe the basic operations of a Netherlands Antilles finance subsidiary of a U.S. corporation. A finance subsidiary essentially is a shell company which acts as a conduit for U.S. corporate overseas borrowings. The shell company in the Antilles generally floats a bond issue in a European financial market (typically in London) and the borrowed funds simply "pass through" the Antilles en route to U.S. or foreign subsidiaries of the U.S. parent corporation. Subsequently, interest payments on the bonds made by the parent corporation may flow out of the U.S. tax-free through the Antilles to foreign investors.

To illustrate the significance of U.S. finance subsidiaries, one only has to look at IRS statistics concerning U.S.-source investment income paid to foreigners. About \$3.4 billion in taxable-type U.S.-source interest was reported as paid to foreign persons in 1981. About \$1 billion, or 29 percent, of the \$3.4 billion was paid to individuals or businesses claiming residence in the Netherlands Antilles. This made Antilles' residents the leading world-wide recipients of U.S.-source interest income in 1981. It should be noted, however, that the \$3.4 billion does not reflect all of the U.S.-source interest income earned by foreigners. This is because certain types of U.S.-source interest income are not subject to the statutory U.S. 30-percent withholding tax and are not reported to IRS.

Data available from IRS for 1982 indicates that \$5.2 billion--an increase of \$1.8 billion--in taxable-type U.S.-source interest income was paid to foreigners that year. Of

this amount, almost \$1.5 billion, or 29 percent, was paid to individuals or businesses claiming Antilles residence.

Also, the finance subsidiaries of U.S. corporations generate important tax revenues for the Netherlands Antilles. The tax imposed by the Antilles on offshore finance activities generates about \$150 million in revenues annually for that country, according to Antilles representatives. And the importance of those revenues has increased over the past several years as the other major sectors of the Antilles' economy--tourism, oil refining, and ship repair and servicing--have declined. As a result, according to Antilles representatives, offshore financing activities now generate about 25 percent of that country's national tax revenues. The loss of these activities would have a significant economic impact on the Netherlands Antilles.

Concerning the latter point, a State Department official told us that any further weakening of the Antilles' economy could lead to political instability. The official further noted that the Netherlands Antilles has been a strong ally of the U.S. for many years and that it is strategically located near an area where oil reserves are known to exist. Moreover, the U.S. and Antilles governments recently reached agreement on a mutual assistance treaty for law enforcement matters in general. According to Justice Department officials, the Antilles provides U.S. law enforcement agencies with valuable information concerning drug trafficking between South America and the United States.

Given the benefits being realized by American business and the federal government from our present relationship with the Netherlands Antilles, a question arises as to why there is a need for the Congress to address the issue of the 30-percent withholding tax at this time. The answer lies primarily in the fact that there has been some documented, and much alleged, third-country and U.S. citizen abuse of the U.S.- Netherlands Antilles tax treaty. The Department of the Treasury has neither been able to reach agreement with the Antilles on a new treaty, nor willing to terminate the existing treaty with that country.

TAX TREATY ABUSES

In order to make advantageous use of the U.S. tax treaty with the Netherlands Antilles, a third-country investor must first incorporate a company in that country. Forming a company is not a difficult task, and such a company can be used as an effective conduit for a variety of investments.

Once a company has been formed in the Netherlands Antilles, the investor may proceed to take advantage of that country's treaty network, particularly the treaty with the United States. Although there are several different kinds of Netherlands Antilles companies, some of the more important types are real estate companies and investment companies. The following are examples of how third-country investors can use such companies to benefit from the U.S. tax treaty with the Netherlands Antilles.

--A real estate company is used primarily to channel funds into U.S. real property, such as apartment buildings and shopping centers. Foreign investors can invest funds

directly in U.S. real estate. But rents and royalties arising from such investments generally are taxed at the 30-percent rate. Also, any capital gains would be subject to tax. By structuring such investments through a Netherlands Antilles company, however, an investor can avoid the 30-percent withholding tax. Furthermore, such investors currently are able to avoid U.S. tax on any capital gains arising from their investments.

--Like a real estate company, an investment company is used primarily to channel funds into the United States. Investment companies, however, generally are used to purchase securities, such as corporate stocks. Again, foreign investors can invest directly in U.S. security markets. In so doing, however, the investor typically encounters the U.S. 30-percent withholding tax. But again, by structuring such transactions through a Netherlands Antilles company, an investor can use the tax treaty to reduce or avoid that tax.

Use of such companies is not limited to third-country residents. In fact, it would also be relatively easy for a U.S. citizen to evade U.S. taxes through use of a Netherlands Antilles company. To do so, with virtual assurance of anonymity, the U.S. citizen needs only to start by establishing a shell company in a tax haven country. Then the shell company can form a Netherlands Antilles company and proceed to take advantage of the tax treaty through investments in the United States.

For several years now, the Department of the Treasury has been seeking to renegotiate the U.S. tax treaty with the Netherlands Antilles in order to incorporate stronger anti-abuse and exchange of information provisions. Antilles negotiators, however, believe that Treasury perceives a need to maintain a treaty relationship so as to assure continued U.S. corporate access to the Eurobond market. This has made it difficult for Treasury to obtain a final agreement with the Antilles on a new,

more effective treaty. Treasury has also been reluctant to terminate the present treaty or the ongoing negotiations.

As a result, the Congress now has been put in the position of having to deal with these problems. In so doing, it will have to choose from among several alternative courses of action and thereby address a series of related issues.

ALTERNATIVE COURSES OF ACTION

There are at least five ways through which to address the issue of U.S. corporate reliance on the Eurobond market. That is, the Congress could

- decide to take no legislative action, thereby seeking to maintain the status quo;
- eliminate foreign tax credits for payments made by subsidiaries of U.S. corporations to the Antilles government;
- enact H.R. 4029 which removes the 30-percent withholding tax on Eurobonds;
- enact that portion of H.R. 2163 which phases out the 30-percent withholding tax over a period of years; or
- enact H.R. 3025 which immediately repeals the 30-percent withholding tax.

In choosing from among these options, the Congress necessarily will address issues relating to U.S. corporate access to the Eurobond market, the economy of the Netherlands Antilles, and tax treaty abuses.

Seeking to maintain the status quo

The first option I would like to discuss involves seeking to maintain the status quo. This would entail (1) retaining the Antilles treaty, at least as it applies to the finance subsidiaries of U.S. corporations and (2) continuing to allow foreign tax credits for tax payments made to the Antilles. This

approach will permit continued U.S. corporate access to the Eurobond market at favorable interest rates; it will also maintain indirect U.S. support for the Antilles economy.

But the Antilles would have no additional incentive to conclude a new tax treaty with the U.S. which would curb treaty abuse by third-country and U.S. persons. Moreover, U.S. taxpayers would continue to subsidize a major part of the costs associated with U.S. corporate use of Antilles finance subsidiaries. This is because the taxes paid by U.S. corporations to the Antilles presently can be credited against the corporations' U.S. tax liabilities.

Eliminating foreign tax credits

A second alternative would be to eliminate the aforementioned foreign tax credits, thereby reducing or effectively eliminating the incentive for U.S. corporations to access the Eurobond market through the Netherlands Antilles. Currently, tax payments made by finance subsidiaries to the Antilles may generally be claimed as credits on a dollar for dollar basis against the U.S. parent corporation's tax liability. If U.S. corporations were denied these tax credits, tax payments made to the Antilles would presumably continue to reduce the U.S. parent corporation's tax liability--but not on a dollar for dollar basis. Instead, the tax liability would be reduced at a percentage rate equal to the corporation's marginal tax rate.

According to several securities industry representatives, elimination of the foreign tax credit generally would have the effect of offsetting some of the interest savings available on the Eurobond market. Although we cannot attest to the accuracy of that assertion, there is little doubt that U.S. corporations would have reduced incentives to use the Netherlands Antilles for access to that market. The reduced incentives would also place Treasury in a better position to renegotiate the tax treaty with the Antilles or terminate the existing treaty to eliminate abuses.

But this alternative would have serious, negative effects on the Netherlands Antilles' economy. This is because the Antilles would receive significantly reduced tax revenues from the operations of U.S. corporate finance subsidiaries. Further, if Treasury were to decide to terminate the treaty, revenues derived by the Antilles from real estate companies, investment companies, etc., would be reduced as well.

Eliminating the U.S. withholding tax on Eurobonds

A third option is to adopt H.R. 4029 which would remove the U.S. 30-percent withholding tax only on U.S. corporate bonds issued on the Eurobond market. U.S. corporations could then directly access the Eurobond market at favorable rates, thus eliminating the need for reliance on Netherlands Antilles finance subsidiaries.

H.R. 4029 would not, by itself, solve the problem of Antilles-related tax treaty abuses. However, by eliminating the

need for U.S. companies to go through the Antilles, it would remove the most significant impediment to solving that problem. It would do this by putting the Department of the Treasury in a better position to conclude a revised tax treaty or, if necessary, to terminate the existing treaty. This alternative, too, would have an immediate, negative effect on the Netherlands Antilles' economy.

Phasing out the withholding tax
on Eurobonds and registered securities

H.R. 2163 offers a fourth alternative approach. It would provide for broader access to foreign capital markets than would H.R. 4029. In this regard, H.R. 2163 would exempt both U.S. corporate Eurobond issues and registered securities, such as Treasury bonds, from the 30-percent withholding tax.

The withholding tax, however, would be phased out over several years. This would be accomplished by immediately reducing the 30-percent tax to 5 percent. The tax would then be reduced by one percentage point each year until July 1, 1988, when it would be eliminated.

With respect to U.S. corporate access to the Eurobond market, tax treaty abuses, and effects on the Antilles' economy, adoption of the approach set forth in H.R. 2163 ultimately would have some effects similar to those associated with H.R. 4029. That is, once the tax has been phased out, the following could occur:

--U.S. corporations no longer would find it advantageous to rely on Netherlands Antilles finance subsidiaries.

--Treasury would be in a stronger position with respect to treaty negotiations with the Antilles.

--The economy of the Antilles would be negatively affected, unless it developed new money-making initiatives during the phase out period to replace the revenues derived from its offshore finance activities.

One important difference between the two bills is that, under H.R. 2163, all affected parties--the securities industry, the Treasury Department, and the Netherlands Antilles--would have several years to prepare and plan ways in which to adapt to a revised Eurobond financing system.

A second and perhaps more important difference between the two bills is that, besides affecting Eurobond financing methods, H.R. 2163 could also have the effect of opening up U.S. capital markets by removing the withholding tax on registered securities as well as on Eurobonds. This could have far-reaching and, as yet, unpredictable effects on international capital markets. It could also directly affect the tax policies of other countries. For example, tax authorities from France told us that, if the U.S. were to eliminate its 30-percent withholding tax on interest, they also would have to consider eliminating their withholding tax. They would have to do so in order to remain competitive with the U.S. in attracting foreign investment.

Immediate repeal of the
30-percent withholding tax

Like H.R. 2163, H.R. 3025 would eliminate the U.S. 30-percent withholding tax on both Eurobonds and registered securities. It differs from H.R. 2163, however, in one major way--it repeals the tax immediately rather than phasing it out over a period of years.

H.R. 3025 would immediately facilitate U.S. corporate access to the Eurobond market and would put Treasury in a stronger negotiating position with the Antilles. But H.R. 3025 would have an immediate, negative effect on the economy of the Antilles. This is because, unlike H.R. 2163, H.R. 3025 offers no phase-out period and thus affords the Antilles no interim time period during which to adjust to the impending loss of tax revenues. Furthermore, H.R. 3025 could also have immediate and unpredictable effects on capital markets and on the tax policies of other countries.

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In sum, Mr. Chairman, this Committee and, indeed, the Congress as a whole face a most difficult task. Each of the options presently before you involve unknowns. In that respect, the least predictable of the options in terms of their effects are H.R. 3025 and H.R. 2163. More predictable are the effects of H.R. 4029. Even so, the data available are not sufficient for us to give you the "ideal" answer.

This concludes my prepared statement. We would be pleased to respond to any questions.