Overview of U.S. Interest Income, Exempt from U.S. Income Taxation for the Foreign Investor ("Portfolio Interest") ©

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Total foreign investment in U.S. debt instruments is immense. The U.S. Treasury reports that foreign portfolio investment in U.S. long-term securities, such as stocks and debt instruments with an original term-to-maturity in excess of one year has increased at a rapid rate during the 1990s. Foreign investments in U.S. Treasury Debt went from USD$ 463.5 billion in 1994 to USD$ 5,468 billion in 2017. Interestingly, of the total USD$ 12.3 trillion of total U.S. Treasury Debt in 2017, 44.7 percent was owned by foreign investors.

Foreign Portfolio Investment in Long-Term Securities by Type of Security (Source: U.S. Treasury Department)[1] (Amounts in USD$ Billions)

Type of Security	1994	1997	2000	2002	2004	2005	2006	2007	2008	2009
U.S. Agency Debt	107.1	252	261	492	623	791	984	1,304	1,464	1,196
Corporate and Municipal Debt	275.6	572	703	1,130	1,429	1,729	2,021	2,738	2,820	2,440
Equities	397.8	929	1,709	1,395	1,904	2,144	2,430	3,130	2,969	2,252
U.S. Treasury Debt	463.5	1,053	884	908	1,462	1,599	1,727	1,965	2,211	2,604
Totals	**1,244.0**	**2,806**	**3,557**	**3,925**	**5,418**	**6,263**	**7,162**	**9,137**	**9,463**	**8,492**

Type of Security	2010	2011	2012	2013	2014	2015	2016	2017
U.S. Agency Debt	1,086	1,031	991	874	827	880	954	980
Corporate and Municipal Debt	2,493	2,651	2,549	2,672	2,974	3,217	3,505	3,844
Equities	2,814	3,830	4,237	5,070	6,356	6,655	6,186	7,189
U.S. Treasury Debt	3,343	4,049	4,673	4,916	5,382	5,450	5,585	5,468
Totals	**9,736**	**11,561**	**12,450**	**13,532**	**15,539**	**16,202**	**16,230**	**17,481**

The historical strength of the U.S. economy and the traditional security of dollar denominated investments are two important factors for these increases in indirect foreign investment into the U.S. The U.S. tax benefits to foreign investors are another very important factor.

U.S. Income Tax Benefits

There are two general tax concepts that are important regarding U.S. debt investments made by foreign investors. First, the federal withholding tax of 30 percent, or lower income tax treaty rate, may be applied to U.S. source interest income earned by the foreign investor. Prior to January 1, 1994, the withholding

[1] *Based on the information of the Report on Foreign Portfolio Holdings of U.S. Securities, as of June 30, 2017, available at:* *https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/fpis.aspx*

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tax on all debt instruments, except "portfolio interest" debt instruments (with Mexican lenders/investors), was generally 30 percent on the gross amount of the interest payments. The U.S./Mexico Income Tax Treaty reduces the rate imposed on these interest payments depending upon who is payor of the interest, to 4.9 percent, 10 percent or 15 percent.[2]

Second and most importantly, the U.S. exempts from taxation, qualifying "portfolio interest" earned by the foreign investor. "Portfolio interest" is exempt from U.S. taxation without regard to the residency of the foreign investor (e.g., Mexico, British Virgin Islands, Hong Kong, Cayman Islands or United Kingdom) and without regard to any U.S. income tax treaty. "Portfolio interest" is the focus of this overview.

To reiterate, "portfolio interest" from U.S. sources received by nonresident aliens and foreign corporations is not subject to any U.S. withholding tax and is, therefore, an excellent tool to finance certain U.S. investments.[3] The definition of what is portfolio interest is fairly complicated and is designed to benefit only nonresident individuals and foreign corporations. U.S. citizens and resident aliens must pay tax on such interest.

Portfolio interest consists of registered obligations[4] which are discussed briefly below.

Registered Obligations

A debt instrument is a registered obligation if: (1) the obligation is registered as to both principal and any stated interest and any transfer of the obligation may be accomplished only through the surrender of the old instrument to the new holder, or (2) the contractual right to the principal and stated interest can be transferred to another person only through a book-entry system; and (3) the U.S. withholding agent[5] receives a statement that the owner is not a U.S. person[6].

In the case of U.S. Treasuries, the U.S. Treasury Department has "only issued [Marketable Treasury Securities] securities in book-entry form" since 1986. Indeed, an "overwhelming amount (99.84 percent

of outstanding marketable securities) exist in book-entry form. Securities in book-entry form exist not as printed certificates but rather as computer records on . . . [the Treasury Department's] books and on the books of banks and government securities brokers and dealers."[7]

[2] *See Article 11 of the U.S. – Mexico Tax Treaty*

[3] I.*R.C. §§871(h) and 881(c). The term "portfolio interest" includes certain bearer obligations targeted to foreign persons (i.e., non U.S. persons) issued before March 18, 2012. See § 502 of the HIRE Act.*

[4] I.*R.C. §§163(f) and 871(h)*

[5] *The withholding agent that receives the certificate of foreign status must make an information return on IRS Form 1042S of the payment with respect to which the certificate of foreign status is required for the calendar year. The withholding agent must attach the certificate (IRS Form W8BEN) along with the IRS Form 1042S.*

[6] The *statement must certify that the beneficial owner is not a citizen or resident of the U.S., and must set forth the name and address of the beneficial owner. This statement requirement can be made either by the beneficial owner or by securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business. For instance, if a corporation commonly holds securities for its nonresident alien customers, it could provide the statement to the U.S. withholding agent that would otherwise withhold the rate of tax from the interest payment. This requirement is met if the institution that initially holds the customers' securities in the ordinary course of its trade or business states under penalty of perjury that it has received from the beneficial owner an IRS Form W8BEN stating that the owner is a nonresident alien.*

[7] *www.publicdebt.treas.gov/.*

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Special Restrictions

In addition to the requirements set forth above, "portfolio interest" does not include interest paid to any of the following types of foreign investors:

1. Anyone who owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote in the U.S. borrower;

2. A foreign bank on an extension of credit in the ordinary course of its trade or business; or

3. A controlled foreign corporation from a related person.

Also, any interest that is "contingent interest" and is determined with reference to receipts, sales, etc., does not qualify as "portfolio interest".

There are complicated "attribution rules" that apply to the 10 percent shareholder restriction described above. For example, if Father (F) owns 100 percent of U.S. Corporation (U.S. Corp) and his two children (C1 and C2) both own 50 percent each of the foreign lender corporation (FC), then F is deemed to be the owner of FC by virtue of C1 and C2s' actual ownership in the foreign corporation. Similarly, if a subsidiary of FC2 obtains a loan from U.S. Corp, the interest payments would not qualify.

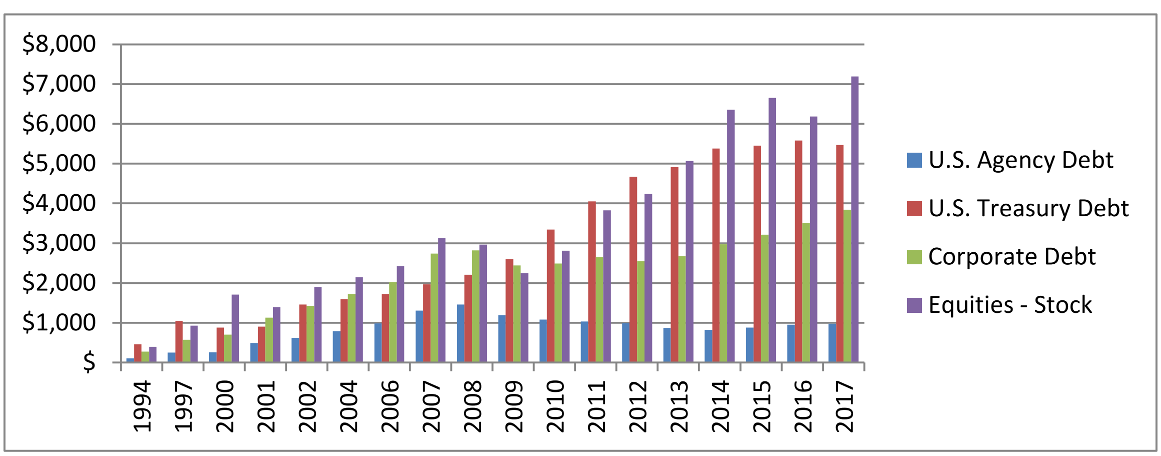
Finally, it is important to mention that the "Tax Cuts and Jobs Act" signed into law on December 22, 2017, does not contemplate any change on the above mentioned.

Summary

Although many technical requirements must be satisfied to assure a foreign investor that the U.S. interest is "portfolio interest," the tax benefits are significant to both the foreign lender who pays no U.S. tax and the U.S. borrower (who may be able to deduct the costs of interest payments it makes to the foreign investor).

The diagram below (in USD$ billions) summarizes the rapid increase in foreign investment in the U.S. (much of which qualifies as "portfolio interest" and therefore exempt from U.S. taxation). It appears this trend of increased foreign portfolio investment will only continue.

Foreign Portfolio Investment in Long-Term U.S. Securities



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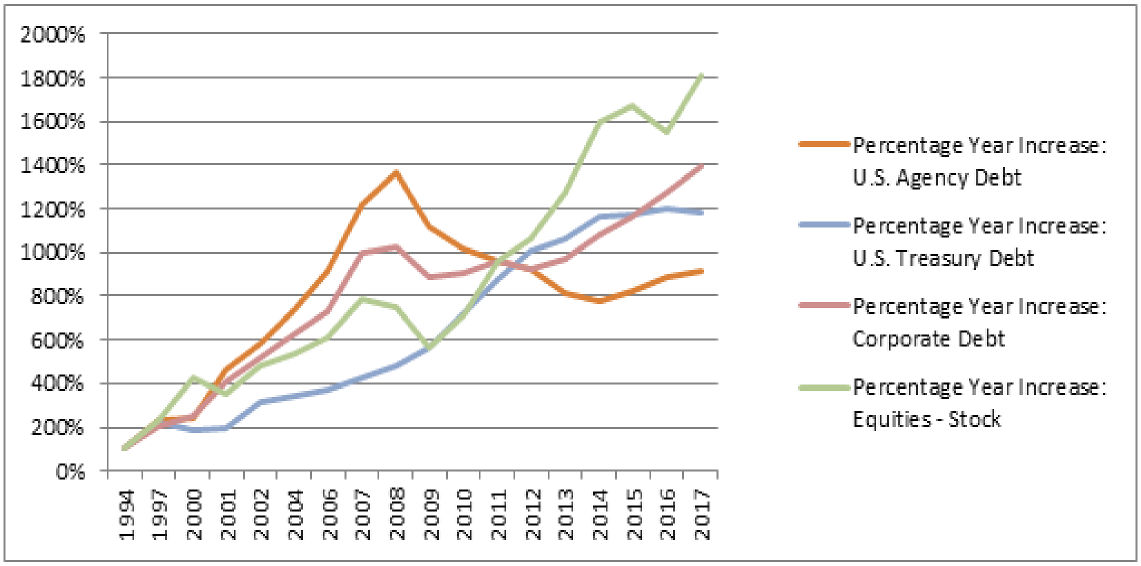
Foreign Portfolio Investment in Long-Term U.S. Securities
(Percentage Increases)



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