UNC SCHOOL OF LAW

NORTH CAROLINA JOURNAL OF INTERNATIONAL LAW AND COMMERCIAL REGULATION

Volume 9 | Number 1 Article 5

Winter 1983

The Use of International Finance Subsidiaries in the Netherlands Antilles

Ronald G. Hock

Follow this and additional works at: http://scholarship.law.unc.edu/ncilj

Part of the Commercial Law Commons, and the International Law Commons

Recommended Citation

Ronald G. Hock, *The Use of International Finance Subsidiaries in the Netherlands Antilles*, 9 N.C. J. Int'l L. & Com. Reg. 51 (1983).
Available at: http://scholarship.law.unc.edu/ncilj/vol9/iss1/5

This Article is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Journal of International Law and Commercial Regulation by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.

The Use of International Finance Subsidiaries in the Netherlands Antilles

By Ronald G. Hock*

The use of the international finance subsidiary (IFS) as a means of obtaining investment capital began in response to a 1960's foreign investment program designed to correct the United States balance of payments deficit.[1] By facilitating the flow of capital into the United States, and impeding the flow of capital out of the United States, the program prompted the international tax bar into developing new techniques for reaching the "tainted" overseas capital markets. While the balance of payments program has largely been dismantled, the IFS continues to be a valuable means of access to the vast reservoir of investment capital located overseas, particularly in the Eurobond market.[2]

The primary purpose of an IFS is to enable its domestic parent corporation to borrow overseas at a cost lower than that which would be available domestically.[3] Because the existing United States regulatory scheme may exempt overseas lenders from withholding tax on the inter-

---

* B.S. 1980, State University of New York at Albany; J.D. 1983, Duke University School of Law. LL.M. Taxation, New York University, expected May 1984. The author wishes to acknowledge Professor Pamela B. Gann, Duke University School of Law, who sponsored the independent study out of which this article grew.

[1] Bittel, *Offshore Financing for United States Business Ventures*, 48 IND. L.J. 43, 57-59 (1972). The program consisted of the following steps:

1. Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960, 1006-27 (codified as amended at I.R.C. §§ 951-964 (1976 & Supp. V 1981)) (eliminating deferral of income tax on some offshore profits, whether or not repatriated).
2. Interest Equalization Tax Act, Pub. L. No. 88-563, 78 Stat. 809 (1963) (codified as amended at I.R.C. §§ 4911-4920 (1976 & Supp. V 1981)) (placing a tax on the purchase of certain foreign securities and debt obligations).
3. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539 (codified as amended in scattered sections of I.R.C.) (providing inducements for offshore investors to invest in the United States).
4. Foreign Direct Investment Regulations, 15 C.F.R. §§ 1000.101-.1407 (1974) (repealed 1976) (restricting offshore investments by U.S. persons).
5. Currency and Foreign Transactions Reporting Act, Pub. L. No. 91-508, 84 Stat. 1114, 1122-23 (1970) (providing for reporting of all international money transactions involving more than $5000).

[2] Gelinas, *Tax Considerations for U.S. Corporations Using Finance Subsidiaries to Borrow Funds Abroad*, 7 J. CORP. TAX'N 230, 231 nn.2,3 (1980). For an in-depth discussion of the Eurobond market, see Newburg, *Financing in the Euromarket by U.S. Companies: A Survey of the Legal and Regulatory Framework*, 33 BUS. LAW. 2171, 2178-84 (1978).

[3] This statement is true provided U.S. interest rates are higher than foreign interest rates.

est they receive,[4] their after-tax yield will increase, and the nominal interest rate they demand from ultimate United States borrowers will decrease correspondingly.[5]

The recent downward trend in U.S. interest rates has lessened the advantage of borrowing overseas. *See* Gelinas, *supra* note 2, at 231.

A secondary purpose for creating an IFS is to avoid the strict registration requirements of U.S. securities law. *See generally* L. LOSS, SECURITIES REGULATION 159-708 (1961). These requirements apply to "trade or commerce in securities . . . among the several States or between . . . any Territory of the United States and any State or other Territory, or between any foreign country and any State [or] Territory." Securities Act of 1933, § 2(7), 15 U.S.C. § 77b(7) (1982). *See also id.* § 5, 15 U.S.C. § 77e (1982). Exemption from registration under U.S. securities law can thus be attained by taking careful steps to assure that no securities will be sold to a U.S. beneficial owner. For a more complete discussion of the procedures which will cause the Securities and Exchange Commission to issue "no-action" letters, see Newburg, *supra* note 2, at 2186.

Other purposes for creating an IFS include early redemption and other options not available for borrowings of comparable maturities in the U.S. market, debt covenants that are more flexible than those required for comparable U.S. obligations, greater speed in completing the offering, and acquisition of foreign currency. *See* Gelinas, *supra* note 2, at 231 n.3.

[4] The following excerpt from the offering circular of Beatrice Foods Overseas Finance N.V., April 26, 1978, is typical of a Netherlands Antilles issuance:

> In the opinion of United States counsel for Overseas and Beatrice, under present United States Federal income tax law and under the terms of the present Income Tax Convention between the United States of America and the Kingdom of the Netherlands, as extended to the Netherlands Antilles, interest paid by Overseas will be exempt from United States Federal income tax unless the recipient is a citizen, resident or corporation of the United States and . . . under present United States Federal estate tax law, the Notes will not be subject to United States Federal estate tax if held by persons who are not residents or citizens of the United States at the time of death.
>
> No rulings have been requested from the United States Internal Revenue Service because the Internal Revenue Service is no longer willing to issue rulings with respect to the question of whether obligations of "finance subsidiaries," such as the Notes, constitute the indebtedness of such a subsidiary. In September 1974, the Internal Revenue Service published a ruling which stated that "the mere existence of a five to one debt to equity ratio . . . should no longer be relied upon as a basis for concluding that debt obligations of a finance subsidiary constitute its own indebtedness, and it revoked certain published rulings (including those referred to below) that reached such a conclusion where there was such a debt to equity ratio.
>
> In rendering such opinion, United States counsel for Overseas and Beatrice has relied on the Internal Revenue Service's administrative interpretation of the law, evidenced by published rulings of general applicability and private rulings with respect to specific obligations, including outstanding obligations of Overseas. The opinion of counsel is also based on representations by Overseas and Beatrice with respect to the assets, liabilities and income of Overseas, including a representation that the value of Overseas' equity capital at the time the Notes are issued will be at least $62,000,000. It is the intention of Overseas and Beatrice that Overseas will operate in accordance with such representations.

Id. at 30, *reprinted in* Lederman, *The Offshore Finance Subsidiary: An Analysis of the Current Benefits and Problems,* 51 J. TAX'N 86, 87 n.2 (1979).

[5] When a parent corporation contemplates the raising of investment capital through creation of a finance subsidiary, it must make a key planning decision: whether to utilize an IFS or a domestic finance subsidiary (DFS). Use of a DFS is limited by I.R.C. § 861 (1976 & Supp. V 1981), which states that in order to be exempt from U.S. witholding tax on interest paid to nonresidents, a U.S. corporation must derive less than 20% of its gross income from U.S. sources. If the DFS will invest the loan proceeds in foreign subsidiaries or affiliates, the customary course of action is organizing a DFS (typically in Delaware) to issue the securities. Where a substantial part of the loan proceeds will be invested in domestic operations, a DFS is unlikely to have sufficient foreign source income to meet the § 861 test. In such a case, the use of an IFS is

Recent IFS bond issues have exhibited the following general pattern:

> The exemption of the foreign bond holders from U.S. withholding tax is sought to be accomplished by the parent forming an offshore finance subsidiary. That subsidiary issues bonds to foreigners, and in turn on-loans the bond issue proceeds to the U.S. parent. It is expected by the U.S. parent that no U.S. withholding tax will be imposed on the interest paid by the U.S. parent to the offshore finance subsidiary, assuming the offshore finance subsidiary is incorporated in a country with a treaty providing an exemption from U.S. withholding tax on U.S. corporate interest income. It is also expected that no U.S. withholding tax will be imposed on interest paid by the offshore finance subsidiary to its foreign bondholders.[6]

The first part of this article enumerates the terms of a typical IFS debt offering. The second part describes why the Netherlands Antilles has developed into such a popular incorporation site for an IFS. The third part discusses the desired tax treatment of a Netherlands Antilles IFS financing scheme from the point of view of the respective parties involved. The fourth part analyzes the weapons the Internal Revenue Service has at its disposal to attack a questionable IFS arrangement, and provides a contemporary example of such an attack. The fifth part discloses the tax-avoidance problems posed by the use of the IFS from the standpoint of the Treasury of the United States and the means it has proposed to combat these problems in the future. Finally, the paper concludes that the ultimate tax treatment of Netherlands Antilles IFSs will depend upon the resolution of conflicting policy considerations relating to the flow of investment capital in an out of the United States.

I. Typical Terms of an IFS Debt Offering

An IFS debt offering, in order to be marketable, must be structured to satisfy the objectives of the foreign lenders, as well as those of the U.S. parent corporation and the IFS. Typically, the debt offering includes the following terms:

1. The bonds will be issued in bearer form, with the person presenting the coupons or the bond itself at maturity receiving payment.
2. The bonds will be issued in denominations of one thousand United States dollars, normally at a seven and one-half to ten percent fixed rate of interest, but occasionally at a floating rate established by a fixed margin above the London Inter-Bank Offered Rate (LIBOR).
3. Payments of interest and principal on the bonds will be fully guaranteed by the United States parent corporation.

---

advisable. *See* Newburg, *supra* note 2, at 2189-90. This article assumes that most of the loan proceeds will flow to domestic operations, so that use of an IFS will be most appropriate.

[6] Lederman, *supra* note 4, at 86.

4. Both the U.S. parent corporation and the IFS will indemnify the foreign bond holders for any U.S. withholding tax liability imposed.
5. The bonds will be callable by the IFS if the Internal Revenue Service imposes withholding tax liability upon interest payments and may be callable by the IFS if, after five years, interest rates have fallen by a certain amount.
6. The bonds may be convertible into the United States parent corporation's stock.
7. The bonds will be registered for trading on a European securities exchange, typically the Luxembourg or London exchanges.
8. The bonds will be distributed by foreign underwriters.[7]

II. Advantages of the Netherlands Antilles

A United States parent corporation willing to enter the overseas capital market will prefer the most favorable conditions possible for its IFS. Accordingly, a so-called "tax haven" will usually be chosen as the incorporation site of the IFS. While a tax haven is not easily defined, one commentator has offered the following definition: "any piece of ground which is above sea level at low tide, and which has no need for Internal Revenue."[8] This definition, although overbroad, captures the essence of a tax haven as it relates to the use of an IFS — a jurisdiction which confers tax benefits upon an IFS which would not ordinarily be available to its parent corporation in its country of residence.

The Netherlands Antilles may, at present, be the most suitable of the tax havens used as an incorporation site for an IFS[9] due to the fol-

[7] *See* Gelinas, *supra* note 2, at 232; Lederman, *supra* note 4, at 86.

[8] *The Use of Offshore Tax Havens for the Purpose of Evading Income Taxes: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means,* 96th Cong., 1st Sess. 2 (1979) (statement of M. Carr Ferguson).

[9] The difficulty in defining a tax haven makes identifying existing tax havens even more difficult. The Internal Revenue Service Tax Audit Guidelines now provide a non-exclusive list of thirty tax haven countries. The countries listed are:

1. Antigua	16. Isle of Man
2. Austria	17. Liberia
3. Bahamas	18. Liechtenstein
4. Bahrain	19. Luxembourg
5. Barbados	20. Monaco
6. Belize	21. Nguru
7. Bermuda	22. The Netherlands
8. British Virgin Islands	23. The Netherlands Antilles
9. Cayman Islands	24. Vanuatu (formerly New Hebrides)
10. Costa Rica	25. Panama
11. Channels Islands	26. Singapore
12. Gibralter	27. St. Kitts
13. Grenada	28. St. Vincent
14. Hong Kong	29. Switzerland
15. Ireland	30. Turks and Caicos Islands

Internal Revenue Manual, Part IV, exhibit 500-13. *See* Green, *Current Developments*, 8 INT'L TAX J. 291, 291-92 (1982).

lowing characteristics:[10]

1. unobtrusive currency and exchange controls;
2. efficient communication and transportation systems;
3. political and economic stability;
4. well-developed banking and legal systems;
5. relatively low income tax rates to the IFS;
6. absence of estate or inheritance taxes on the value of Netherlands Antilles debt obligations held by non-residents;
7. bank secrecy laws which permit a high degree of confidentiality for foreigners transacting business;
8. freedom from withholding taxes on payments of interest to foreign lenders on Netherlands Antilles debt obligations; and
9. favorable tax treatment for IFSs of United States parent corporations as the result of a tax treaty with the United States.[11]

The main reason United States parent corporations find the Netherlands Antilles to be a popular incorporation site is undoubtedly the applicability of the United States-Netherlands Income Tax Convention, as extended by protocol to the Netherlands Antilles.[12] Articles XII and VIII contain two major advantages of the treaty.

Under Article XII, provided the recipient is not a citizen, resident, or corporation of the United States, interest paid by a Netherlands Antilles corporation is exempt from United States withholding tax, whether or not the IFS is deemed to be engaged in a trade or business within the United States.[13] Under Article VIII, provided the interest income is not effectively connected with a permanent establishment in the United States, interest received by a Netherlands Antilles IFS from its United States parent corporation will be exempt from United States income tax.[14] This characterization should be avoided if the IFS has no offices in the United States, the loan to the United States parent corporation was made in the Netherlands Antilles, and if two additional conditions are satisfied. First, assuming that the IFS will be lending the proceeds of

---

[10] *See* Dimitruk, *Setting Up a Netherlands Antilles Company*, in FOREIGN TAX HAVENS 125 (Prac. L. Inst. 2d ed. 1974); Kanter, *The Netherlands Antilles*, in FOREIGN TAX HAVENS (Prac. L. Inst. 1973). *See generally* Boffa, *International Finance Subsidiaries*, 215 TAX MGMT. (BNA) A-14 (2d ed. 1972); Curacao Int'l Trust Co. N.V., Netherlands Antilles, in GRUNDY'S TAX HAVENS 126 (M. Grundy 3d ed. 1974).

[11] Double Taxation Convention, Apr. 29, 1948, United States-Netherlands, 62 Stat. 1757, T.I.A.S. No. 1855 [hereinafter cited as Netherlands Treaty]; Supplementary Protocol, June 15, 1955, United States-Netherlands, 6 U.S.T. 3696, T.I.A.S. No. 3366 [hereinafter cited as 1955 Protocol]; Supplementary Protocol, Oct. 23, 1963, United States-Netherlands, 15 U.S.T. 1900, T.I.A.S. No. 5665 [hereinafter cited as 1963 Protocol].

[12] Netherlands Treaty, *supra* note 11; 1955 Protocol, *supra* note 11; 1963 Protocol, *supra* note 11. The U.S.-Netherlands Antilles treaty is currently being renegotiated, and the uncertainty surrounding the negotiations has been reflected in the capital market. *See infra* notes 107-25 and accompanying text.

[13] Netherlands Treaty, *supra* note 11, art. XII, 62 Stat. 1757, 1762, T.I.A.S. No. 1855.

[14] Netherlands Treaty, *supra* note 11, art. VIII, 62 Stat. 1757, 1761 T.I.A.S. No. 1855. *See* Treaty Reg. § 505.304(b) (1983).

its debt offering to the United States as opposed to foreign affiliates, the IFS must elect to be taxed on its United States source income at the full Netherlands Antilles corporate tax rates (24-30 percent),[15] rather than at the extremely favorable investment or holding company rates (2.4-3.0 percent).[16] Second, assuming that the interest payments on the IFS debt issue are not being paid to foreign banks, a favorable tax ruling is required from the local tax authorities in order for the IFS to be able to deduct its payments of interest for the purposes of determining its Netherlands Antilles taxable income. Such a ruling should be granted provided the IFS has a net taxable income of at least one percent of the first eighty million dollars principal amount of its outstanding issue, and the bonds are listed on a recognized securities exchange.[17]

III. Desired Tax Treatment

Analysis of the United States tax treatment of an IFS financing scheme involves both statutory and treaty considerations. This analysis will proceed from the standpoint of the respective parties involved — the United States parent corporation, the Netherlands Antilles IFS, and the foreign lenders.

A. United States Parent Corporation

The United States parent corporation will be able to deduct the interest it pays to its Netherlands Antilles IFS as an ordinary and necessary business expense.[18] The IFS will prepare a Form 1001 claiming the applicability of treaty Article VIII, and enabling the United States parent corporation to make its interest payments to its IFS without withholding any tax.[19]

Assuming that the Netherlands Antilles IFS is a controlled foreign corporation,[20] the United States parent corporation must include in current income its pro rata share of the IFS's earnings and profits under the

---

[15] Landsverordening op de Winstbelasting 1940, art. 15 (Netherlands Antilles) [hereinafter cited as Lands. Winst.], *reprinted in* CORPORATE TAXATION IN THE NETHERLANDS ANTILLES 69 (A. Amador & F. Leo trans. 1978) [hereinafter cited as A. Amador & F. Leo].

[16] Lands. Winst., *supra* note 15, art. 14, *reprinted in* A. Amador & F. Leo, *supra* note 15, at 48-60; 1963 Protocol, *supra* note 11, art. I(1), 15 U.S.T. 1900, 1901-02, T.I.A.S. No. 5665.

[17] Lands. Winst., *supra* note 15, art. 6(c), *reprinted in* A. Amador & F. Leo, *supra* note 15, at 19-21. *See* Gelinas, *supra* note 2, at 241.

[18] I.R.C. § 162(a) (1976) ("[O]rdinary and necessary expenses paid or incurred . . . in carrying on any trade or business" are deductible); *id.* § 163(a) (1976) (interest paid on indebtedness is deductible). The IFS may, however, be unable to deduct separately the interest it pays on its debt by foreign lenders. *See infra* notes 56-58 and accompanying text.

[19] Treas. Reg. § 1.441-6, 26 C.F.R. § 1.1441-6 (1983).

[20] A foreign corporation will be deemed a "controlled foreign corporation" (CFC) if more than 50% of its voting stock is owned by "United States shareholders" on any day during its taxable year. I.R.C. § 957(a) (1976). For this purpose, a "United States shareholder" is a U.S. "person" owning 10% or more of a corporation's voting stock. I.R.C. §§ 951(b), 957(d) (1976). In addition, stock held by parties related to a shareholder (i.e. family members, corporations, partnerships, trusts and estates), may be considered constructively owned by the shareholder.

Subpart F and investment in United States property rules.[21] This amount will typically equal the spread between the interest the IFS receives from its United States parent corporation and the interest it pays to its foreign bondholders, less Netherlands Antilles taxes and other expenses.[22]

The United States parent corporation may gross-up and credit against its United States tax liability the Netherlands Antilles income tax

---

I.R.C. §§ 985, 318 (1976 & West Supp. 1983). *See generally* D. TILLINGHAST, TAX ASPECTS OF INTERNATIONAL TRANSACTIONS 174-79 (1978).

An intriguing concept in this area is that of the group finance subsidiary. Essentially, a group of similarly situated seekers of investment capital may form an IFS which avoids CFC status, and thus avoids the loss of income recognition deferral associated with CFC status. This concept is discussed more fully in Gilburn & White, *Tax Aspects of International Financing Operations*, 6 TAX PLAN. INT'L 209-12 (1979); Reiner, *Using Tax Havens Can Save U.S. Tax on Foreign Operations of Corporations, Individuals*, 23 TAX'N FOR ACCT. 240, 241 (1979).

[21] Under the Subpart F rules, if a foreign corporation is a CFC for an uninterrupted period of thirty days or more during any taxable year, each of its United States shareholders owning stock on the last day in such year must generally include in gross income its pro rata share of the CFC's "Subpart F income" for the year. I.R.C. § 951(a) (1976). Subpart F income equals the sum of:

1. Income derived from the insurance of United States risks, *see* I.R.C. § 953 (1976);
2. Foreign base company income, including foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil related income, *see* I.R.C. § 954 (1976);
3. International boycott income, *see* I.R.C. § 999; and
4. Amounts of illegal bribes, kickbacks, or other payments paid by or on behalf of the CFC directly or indirectly to any government's officials, employees, or agents.

I.R.C. § 952(a) (1976).

The amount of Subpart F income a United States shareholder must include in gross income is reduced by dividends received from the CFC and is limited by its pro rata share of the CFC's earnings and profits. I.R.C. §§ 951(a)(2), 952(c) (1976). If less than ten percent of the total gross income of a CFC is of a character which would give rise to Subpart F income, none of the corporation's income will be taxable under Subpart F. I.R.C. § 954(b)(3)(A) (1976). For a more complete discussion of the Subpart F rules, see D. TILLINGHAST, *supra* note 20, at 174-79.

Under the investment in United States property rules, if a foreign corporation is a CFC for an uninterrupted period of thirty days or more during any taxable year, each of its United States shareholders owning stock on the last day in such year must generally include in gross income its pro rata share of the CFC's increase in earnings invested in United States property for the year. I.R.C. § 951(a)(1)(B). United States property is generally defined as properties acquired after December 31, 1962, which are:

1. Tangible properties located in the United States;
2. Stocks of domestic corporations;
3. Obligations of United States persons; and
4. Rights to the use in the United States of: patents or copyrights; inventions, models, or designs (whether or not patented); secret formulas or processes, or any other similar property rights acquired or developed by the CFC for use in the United States. I.R.C. § 956(b) (1976).

The amount of the increase in earnings invested in United States property a United States shareholder must include in gross income is reduced by previously taxed earnings and profits of the CFC and is limited by the shareholders' pro rata share of the CFC's earnings and profits. I.R.C. §§ 956(a), 959(a) (1976).

[22] Reducing this spread to zero by equalizing the two interest rates is a tempting option. However, the favorable tax ruling which must be obtained from Netherlands Antilles taxing authorities before interest payments to non-bank, non-resident bondholders are deductible for Netherlands Antilles tax purposes, as well as the negative IRS position on "back-to-back" loans, effectively precludes this option. *See infra* notes 56-58 and accompanying text.

paid by its IFS, assuming it is not in an excess foreign tax credit position.[23] In essence, the Netherlands Antilles income tax paid by the IFS should result in no net cost to its United States parent corporation. In addition, previously taxed earnings and profits of the IFS will incur no further tax upon repatriation to the United States parent.[24]

Constructive Subpart F distributions[25] should be classified as foreign source dividend income, as are actual dividends.[26] This classification effectively permits a United States parent corporation to raise its overall foreign tax credit limitation in exchange for the income gross-up associated with the constructive dividend.[27] In addition, this classification renders the IFS a source converter, converting the parent corporation's interest expense into United States source interest income of the IFS, and back into foreign source dividend income of the United States parent.

---

[23] United States taxpayers may generally credit against their U.S. income tax due the amount of foreign income tax directly payable. (FTC) I.R.C. § 901 (1976 & Supp. V 1981). Creditable taxes are defined as income, war profits, and excess profits taxes, and taxes "in lieu of" income, war profits, and excess profits taxes. I.R.C. §§ 901(b)(1), 903 (1976).

In addition, a domestic corporation which owns at least ten percent of the voting stock of a foreign corporation from which it receives dividends in any year shall be deemed to have paid the proportion of any foreign income, war profits, or excess profits taxes paid or deemed paid by such foreign corporation as the amount of such dividends bears to the accumulated profits of such foreign corporation (out of which such dividends were paid) in excess of such income, war profits, and excess profits taxes (other than those deemed paid). (IFTC) I.R.C. § 902(a) (1976). The domestic corporation must gross-up its income by treating such "deemed paid" tax as a constructive dividend (notwithstanding its inclusion of actual dividends received) by the foreign corporation before being allowed the indirect credit against U.S. tax due. I.R.C. § 78 (1976).

The amount of foreign tax credit (both FTC and IFTC) allowable against U.S. tax due is limited to the proportion of total U.S. income tax due which the domestic corporation's taxable income from sources without the United States bears to the domestic corporation's worldwide taxable income, such fraction not to exceed 1.0. I.R.C. § 904(a) (1976). To the extent that creditable taxes exceed this limit, the excess may be carried back two years and forward five years, in that order, and to the extent the carried-to year's § 904 limit is not exceeded. I.R.C. § 904(c) (1976).

Domestic corporations not electing the foreign tax credit may deduct foreign income tax due from their U.S. taxable income. I.R.C. § 904(c) (1976 & Supp. V 1981). Corporations electing the foreign tax credit may not deduct foreign taxes due from their U.S. taxable income. I.R.C. § 275(a)(4) (1976 & Supp. V 1981).

The IRS has specifically ruled that the foreign tax credit applies to Netherlands Antilles income tax payable. *See* Rev. Rul. 65-16, 1965-1 C.B. 626.

For a more complete discussion of the foreign tax credit, see Dale, *The Reformed Foreign Tax Credit: A Path Through the Maze,* 33 TAX. L. REV. 175 (1978); Geen & Schreyer, *Foreign Tax Credit-Qualification and Computation,* 5 TAX MGMT. (BNA) (4th ed. 1979).

[24] I.R.C. § 959(a) (1976).

[25] A constructive Subpart F distribution occurs when a U.S. shareholder of an IFS includes in his gross income his pro rata share of the IFS's income from investment in U.S. real property. *See* I.R.C. § 951(a)(1)(B) (1976). *See also supra* note 21.

[26] Treas. Reg. § 1.960-1(h), 26 C.F.R. § 1.960-1(h)(1983). *See also* U.S. Internal Rev. Serv., Instructions to Form 1118, Schedule A (1983).

[27] Thus, the "receipt" of the constructive dividend itself should not cause the U.S. parent corporation's overall foreign tax credit limitation to be exceeded.

B. International Finance Subsidiary

Under treaty Article VIII, the IFS will not be liable for United States withholding tax on the interest it receives from its United States parent corporation.[28] Such a result will be permitted provided the payments are not effectively connected with a permanent establishment in the United States.[29] The IFS should then seek to minimize its United States contacts.

Local law permits a Netherlands Antilles corporation which holds only securities to elect to be taxed on its net investment income at investment or holding company rates (2.4-3.0 percent), rather than at customary corporate rates (24-30 percent).[30] However, Article I(1) of the United States-Netherlands Antilles Protocol denies the exemption from withholding on the interest paid by the U.S. parent corporation to its IFS if the IFS elects to be treated as an investment or holding company.[31] Accordingly, the IFS should not elect investment or holding company treatment.

The loss of such an election should not have an adverse economic impact upon a contemplated IFS financing arrangement. First, while the United States withholding tax would have been based on the gross interest income of the IFS, the Netherlands Antilles income tax will be based on the net income of the IFS.[32] Second, while the United States withholding tax would not have been creditable to the United States parent corporation, the Netherlands Antilles income tax paid by the IFS will be.[33] Assuming the United States parent corporation is not in an excess foreign tax credit position, the Netherlands Antilles income tax paid by the IFS will be cost-free to the group.

C. Foreign Lenders

The foreign holder of the debt obligations of an IFS should not incur any United States tax liability. First, interest payments by the IFS to the foreign holders will constitute foreign source income. This will be true even though the interest income of the IFS is treated as wholly non-effectively connected United States source income.[34] Accordingly, the interest received by the foreign lender will be subject to neither United States withholding tax[35] nor withholding at the source.[36] Second, testa-

---

[28] Netherlands Treaty, *supra* note 11, art. VIII, 62 Stat. 1757, 1761, T.I.A.S. No. 1855.

[29] *Id.* art. VII(1), 62 Stat. 1757, 1761, T.I.A.S. No. 1855.

[30] Lands. Winst., *supra* note 15, art. 14, *reprinted in* A. Amador & F. Leo, *supra* note 15, at 19-21.

[31] 1963 Protocol, *supra* note 11, art. I, 15 U.S.T. 1900, 1901, T.I.A.S. No. 5665.

[32] Lands. Winst., *supra* note 15, art. 4, *reprinted in* A. Amador & F. Leo, *supra* note 15, at 15.

[33] *See* I.R.C. § 901 (1976 & Supp. V 1981); Netherlands Treaty, *supra* note 11, art. XIX, 62 Stat. 1757, 1764-65, T.I.A.S. No. 1855.

[34] I.R.C. §§ 862(a)(1), 861(a)(1) (1976 & Supp. V 1981). *See also id.* §§ 862(a)(2), 861(a)(2)(B) (1976 & Supp. V 1981) (same rule applied to dividends).

[35] *See* I.R.C. §§ 871(a)(1), 881(a)(1) (1976).

[36] Treas. Reg. § 1.1441-3(a) (1960); Netherlands Treaty, *supra* note 11, art. XII, 62 Stat. 1757, 1762, T.I.A.S. No. 1825.

mentary transfers by foreign holders of debt obligations of an IFS will not be subject to estate tax in the United States.[37]

IV. Potential Attacks Upon Questionable IFS Arrangements

Achieving the significant benefits an IFS has to offer is not without risk. The Internal Revenue Service, as "sergeant-at-arms" of the United States Treasury, has at its disposal several statutory and judicially-created means of attack with which to undermine an IFS financing arrangement.[38]

A. Disregard of the Corporate Entity

An IFS which exists in form only is subject to attack as a "sham" entity. An often-quoted version of the doctrine of corporate entity was expressed by the United States Supreme Court in *Moline Properties, Inc. v. Commissioner*,[39] as follows:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.[40]

Such a rendition lends support to one commentator's assertion that "[t]he quantum of business activity required is unclear, but the cases indicate that it may be very small."[41] The floor of activity required of an entity appears to have been enumerated by the Second Circuit in *National Investors Corp. v. Hoey*:[42]

> [Case law] declares that to be a separate jural person for purposes of taxation, a corporation must engage in some industrial, commercial, or other activity besides avoiding taxation: in other words, that the term "corporation" will be interpreted to mean a corporation which does some "business" in the ordinary meaning; and that escaping taxation is not "business" in the ordinary meaning.[43]

Under this formulation, a corporation must show that it is accomplishing some valid business result other than the avoidance of taxation. Whether an IFS can satisfy this standard poses a factual inquiry, but one which is capable of some general observation. On the one hand, it may be said that an IFS performs no other significant function than to permit its foreign bondholders to escape United States income and estate taxes.

---

[37] Treas. Reg. § 20.2103-1 (1973); Treas. Reg. § 20.2105-1(u), 26 C.F.R. § 20.2105-1(u) (1983).

[38] *See generally* Gelinas, *supra* note 2, at 248-56; Lederman, *supra* note 4, at 88-90.

[39] 319 U.S. 436 (1943).

[40] *Id.* at 438 (footnotes omitted).

[41] R. Povell, International Finance Subsidiaries Under Attack 6 (Dec. 1, 1982)(unpublished manuscript).

[42] 144 F.2d 466 (2d Cir. 1944).

[43] *Id.* at 468.

On the other hand, it may be argued that the IFS serves as a bona fide borrowing/lending entity which happens to be able to raise funds more cheaply than similarly situated United States entities.[44] Arms-length dealing between the parent corporation and the IFS would further the latter argument. In any event, care should be taken by all concerned parties to ensure that the IFS is treated as a genuinely functioning formal entity.[45]

Particularly relevant to this factual inquiry are the decided cases which recognize the "separateness" of a corporation where use of the corporation is dictated by the wishes of ultimate lenders to a transaction.[46] These cases indicate that corporations created for the primary purpose of facilitating lending transactions serve a valid business purpose. In addition, other decided cases involving foreign corporations seem to have applied standards similar to those applied in the domestic corporation context.[47]

B. Thin Capitalization

An IFS which holds as assets solely the debt obligations of its United States parent corporation will surely be attacked on undercapitalization grounds.[48] The consequences of a successful attack would be a recharacterization of the debt obligations of the IFS as those of its parent, and a denial of the withholding exemption on payments of interest to the IFS.

When the Interest Equalization Tax was in force, the IRS customarily ruled that an IFS debt-equity ratio not greater than five to one would suffice to characterize the bonds held by foreign lenders as the bona fide debt of the IFS, and not of its United States parent corporation.[49] When the Interest Equalization Tax expired in 1974, however, the IRS revoked its prior rulings which had granted this safe harbor.[50]

---

44 This argument should also apply to group finance subsidiaries. *See supra* note 20.

45 Observance of corporate formalities furthers this goal. Examples of steps which may profitably be undertaken include maintaining a separate office, bank account, and adequate books and records, hiring separate employees, holding required meetings, and filing appropriate tax returns.

46 Collins v. United States, 386 F. Supp. 17 (D.C. Ga. 1974), *aff'd per curiam*, 514 F. 2d 1282 (5th Cir. 1975); Paymer v. Comm'r, 150 F.2d 334 (2d Cir. 1945); Strong v. Comm'r, 66 T.C. 12 (1976), *aff'd mem*. 39 A.F.T.R. 2d (P-H) 77-934 (2d Cir. 1977); Rogers v. Comm'r, 1975 T.C.M. (P-H) ¶ 75,289.

47 Bass v. Comm'r, 50 T.C. 595 (1968); Ross Glove Co. v. Comm'r, 60 T.C. 569 (1973); Siegel v. Comm'r, 45 T.C. 566 (1966).

48 *See* Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712 (5th Cir. 1972). *But see* Santa Anita Consol., Inc. v. Comm'r, 50 T.C. 536 (1968).

49 *See, e.g.*, Rev. Rul. 73-110, 1973-1 C.B. 454; Rev. Rul. 69-501, 1969-2 C.B. 233. The Interest Equalization Tax, I.R.C. §§ 4911-4920 (1970 & Supp. V 1975) (expired 1974), was a tax imposed upon the acquisition by a United States person of stock or debt obligations of a foreign corporation. The tax did not apply if immediately after the acquisition the acquiror owned ten percent or more of the foreign corporation. *Id.* § 4905(a) (1970 & Supp. V 1975) (expired 1974).

50 Rev. Rul. 74-464, 1974-2 C.B. 46.

At present, most IFSs have undertaken to maintain more conservative debt-equity ratios.[51] However, the customary practice of the IFS relending its equity to other affiliates of the United States parent corporation creates additional risk.[52] On the one hand, such relending may be equated to a reduction of the United States parent corporation's investment in the IFS, resulting in a corresponding increase in the debt-equity ratio. On the other hand, such relending may further the argument that the IFS was merely acting in furtherance of its existing trade or business as a bona fide borrowing/lending entity.[53]

Maintaining an adequate debt-equity ratio should not be troublesome, however, even when, for business reasons, the IFS relends its equity to other affiliates of the United States parent corporation. Pursuant to one method which has been sanctioned by the IRS in private rulings and implicitly approved in a published ruling,[54] the parent or other affiliate in need of funds may obtain a loan from a foreign bank, and use the proceeds to make an equity contribution to the IFS. The IFS would then deposit the funds in a time account with the foreign bank that had made the original loan. The IRS has approved this method of financing under circumstances where the right of the IFS to withdraw from the time account is not contingent upon the repayment of the original loan and the deposit is not being used as collateral for the loan.[55]

C. *Agency or Conduit*

The IRS could seek to characterize the IFS as a mere agent or con-

---

[51] Following are several examples of 1978 and 1979 issues by foreign subsidiaries and the debt-equity ratios of each:

U.S. Parent of Subsidiary	Incorporation Site of IFS	Amount of Issue ($ millions)	Apparent Debt-Equity Ratio of IFS
1978			
Avco	Netherlands Antilles	25	2.0
Beatrice Foods	Netherlands Antilles	100	3.0
Coca Cola of N.Y.	Netherlands Antilles	30	2.5
Hospital Corp. of America	Netherlands Antilles	25	2.0
IG Industries	Netherlands Antilles	35	2.0
Itel	Netherlands Antilles	25	2.5
J.C. Penney	Netherlands Antilles	100	3.0
1979			
Citicorp	British Virgin Islands	100	3.0
Texas Int'l Airlines	Netherlands Antilles	35	3.0
Sears Roebuck & Co.	Netherlands Antilles	150	2.0

Gelinas, *supra* note 2, at 253 n.89.

[52] Relending to U.S. affiliates of the U.S. parent corporation will trigger the application of the investment in U.S. property rules, I.R.C. § 956 (1976), possibly creating additional current taxable income to the U.S. parent corporation.

[53] By lending funds to additional entities, the IFS would take on additional characteristics of the group finance subsidiary. *See supra* note 20.

[54] *See* Rev. Rul. 69-501, 1969-2 C.B. 233. This ruling was revoked after the expiration of the Interest Equalization tax, since it sanctioned a 5:1 debt-equity ratio. *See supra* note 49.

[55] *See* Boffa, *supra* note 10, at A-14.

duit of the United States parent corporation. Central to such a characterization is a finding that the IFS financing arrangement constitutes in reality nothing more than a "back-to-back" loan. The theory behind this type of finding is that when the debt offerings of the parent corporation and its IFS are compared to each other, and in light of the fact that the United States parent has guaranteed payment of the obligations of the IFS, their substantial similarity indicates that in substance only one debt offering exists, the parent's, and that the IFS is acting as a mere intermediary between the true parties-in-interest.

In *Aiken Industries, Inc. v. Commissioner*,[56] the IRS successfully attacked a successive loan situation involving the use of an intermediary treaty country IFS to avoid the imposition of United States withholding tax upon the ultimate foreign lender. Because the rates of interest paid on the successive debt offerings were identical, the court held that the ultimate foreign lender, and not the treaty country IFS, had "received" the interest paid by the United States parent corporation within the meaning of the applicable treaty. Accordingly, the parent corporation was held liable for the United States withholding tax which it had not withheld from interest payments to its IFS. While *Aiken* involved the transfer of a pre-existing obligation to an after-created IFS, and is therefore distinguishable from the typical IFS financing arrangement, its rationale would seem equally applicable to the typical arrangement.

In Rev. Rul. 72-514,[57] the intermediary lender was ignored where it acknowledged that it was acting as a mere agent, that it had no independent risk of loss upon default of the ultimate borrower, and that the interest rates on the two debt offerings were identical except for a service fee. In Rev. Rul. 78-118,[58] however, the IRS indicated that an intermediary lender would be respected provided it had independent risk of loss upon default of the ultimate borrower, it had substantial assets other than the obligations of the ultimate borrower with which it could absorb losses, and the rates of interest on the two successive offerings were different.

D. Sham Transaction

Another position the IRS may take would concede the "separateness" of the IFS entity, but disregard the form of the transaction on the grounds that it is nothing more than a sham. To be successful with this theory, the IRS must establish that the IFS arrangement in question was devoid of economic substance, and that the taxpayer parent corporation should be treated as though absolutely nothing had occurred.[59] Such a

---

[56] 56 T.C. 925 (1971).

[57] Rev. Rul. 72-514, 1972-2 C.B. 440.

[58] Rev. Rul. 78-118, 1978-1 C.B. 219.

[59] *See* Knetsch v. United States, 364 U.S. 361 (1960); Goldstein v. Comm'r, 364 F.2d 734 (2d Cir. 1966).

standard imposes a great burden on the IRS. A greater likelihood of success might accompany a sham transaction variation of the agency or conduit theory previously described. Such a theory would posit that since the back-to-back loans are contained within a "single economic family," they should be treated as direct borrowings of the parent corporation.[60]

E. *United States Trade or Business or Permanent Establishment*

The IRS may take the position that the IFS is engaged in a "U.S. trade or business" under the Internal Revenue Code,[61] or engaged in a "U.S. trade or business" through a "permanent establishment" under the United States-Netherlands Antilles treaty.[62] In either case, if the IRS can successfully characterize the income of the IFS as effectively connected with such trade or business, the IFS will be liable for regular United States corporate income tax on its net interest spread.[63] In addition, the Netherlands Antilles tax liability of the IFS would not be deductible nor creditable in computing the net United States tax liability of the IFS.[64]

In Rev. Rul. 73-227,[65] an IFS was deemed to be engaged in a trade or business in the United States where it was not incorporated in a treaty country, and where it maintained an office in the United States, performed most of its clerical functions from that office, and made decisions relating to the timing and placement of the borrowings of the IFS in the United States. The ruling thus provides clear guidance as to the types of United States contacts an IFS should seek to avoid.

F. *Exposure*

The IRS may contend that the United States parent corporation's agreement to indemnify the foreign holders of its IFS's obligations against all IRS-imposed withholding taxes, interest, and penalties has economic value, and may be equated to the payment of additional interest.[66] In the event that the primary obligation to pay interest is subject to the withholding tax, the effect of such a determination would be to impose additional withholding requirements upon the United States parent corporation based on this value.[67]

---

60 *See* Rev. Rul. 77-316, 1977-2 C.B. 53.

61 I.R.C. § 882 (1976 & Supp. V 1981).

62 Netherlands Treaty, *supra* note 11, art. III, 62 Stat. 1757, 1759-60, T.I.A.S. No. 1855.

63 I.R.C. § 882 (1976 & Supp. V 1981); Netherlands Treaty, *supra* note 11, art. III, 62 Stat. 1757, 1759-60, T.I.A.S. No. 1855.

64 I.R.C. § 906(b)(1)(B) (1976). *See* Treaty Regs. § 505.116, 26 C.F.R. § 505.116 (1983).

65 Rev. Rul. 73-227, 1973-1 C.B. 338.

66 *See* Treas. Reg. § 1.61-14(a) (1960). *See also* Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929).

67 Excluding interest and penalities, the U.S. parent corporation's theoretical U.S. withholding tax exposure is therefore approximately 43%, and not merely the statutory 30%, of the interest payments. The computation to determine this theoretical exposure proceeds as follows:

G. I.R.C. Section 482

Under I.R.C. section 482, the IRS has broad discretion to reallocate income, deductions, and credits of related taxpayers in order to reflect the true economic substance of business transactions between them.[68] While a detailed discussion of section 482 is beyond the scope of this paper, it is enough to say that the myriad of ways the IRS may use the section to its advantage could have a significant impact upon the United States parent corporation's tax liability.[69]

H. I.R.C. Section 269

Under I.R.C. section 269(a)(1), a United States parent corporation which creates a subsidiary with the principal purpose of avoiding United States income tax by securing an allowance not otherwise available, may be subject to the loss of that allowance.[70] However, the technical question presented as to whether section 269 even applies to IFS financing arrangements,[71] coupled with the IRS' lack of reliance upon the section in its past IFS rulings where it might have been applicable,[72] make it unlikely that the IRS will invoke the section to challenge a withholding tax exemption in the future.

I. The Texas International Airlines, Inc. Audit

The spectre of an IRS audit attack aided by one or more of the above-described weapons looms large over each Netherlands Antilles IFS financing arrangement. That spectre became reality for Texas International Airlines, Inc. in the spring of 1982, when the Houston district office of the IRS assessed a $1.2 million withholding tax deficiency against the company based on two of its Netherlands Antilles IFS Eurodollar borrowings.[73] Moreover,

> [w]hile the $1.2-million deficiency which the Houston district office of the IRS says the company owes may seem like a drop in the bucket in what some say is a $50-billion market, investment bankers and tax specialists argue that the subsidiaries established by Texas International are similar to hundreds of others now in place and that a popular and ex-

---

Where: x = theoretical U.S. withholding tax exposure
$.30$ = statutory U.S. withholding tax rate

$$x = .30(1 + x)$$
$$= .30 + .30x$$
$$.70x = .30$$
$$x = .429$$

[68] I.R.C. § 482 (1976).

[69] For a general discussion of § 482, see Lewis, *Allocations (Sec. 482) General Coverage*, 327 TAX MGMT. (BNA) (1978).

[70] I.R.C. § 269(a)(1) (1976).

[71] An IFS financing arrangement reduces not the U.S. parent corporation's tax liability, but the liability of the foreign bondholders.

[72] *See, e.g.*, Rev. Rul. 79-65, 1979-1 C.B. 458; Rev. Rul. 69-377, 1962-2 C.B. 231.

[73] *See Closing a Loophole: Corporate Tax Haven in Netherlands Antilles is Bracing for a Disaster*, Wall St. J., Oct. 11, 1982, at 17, col. 2 [hereinafter cited as *Closing a Loophole*].

panding source of financing is seriously threatened.[74]

While details of the Texas International audit are unavailable, sources have revealed the theories the IRS has used in its ongoing audit of a similarly situated taxpayer. In this specific audit situation, "[b]asically, the agent proposes to use Code Section 482 to allocate the investment income earned by the subsidiary to the U.S. parent and to use a 'conduit' theory to require withholding on the finance subsidiary's interest payments."[75]

In justifying an I.R.C. section 482 reallocation of income, the agent appears to have relied upon what he initially perceived to be the following factors: the finance subsidiary was located in the Netherlands Antilles — a "tax haven"; the finance subsidiary had no employees; the finance subsidiary incurred only nominal expenses; most of the negotiations for the borrowing took place prior to the formation of the finance subsidiary; nothing of importance was done in the Netherlands Antilles; the U.S. parent guaranteed the obligation of the finance subsidiary; and the investment decisions of the finance subsidiary were made outside the Netherlands Antilles.[76]

The consequences of this section 482 reallocation are to recharacterize the foreign source income of the IFS as United States source income and, possibly, to make the Netherlands Antilles taxes paid on that income not creditable.[77] The agent has indicated that competent author-

---

[74] 1982 DAILY TAX REP. (BNA) No. 169, at G-6 (Aug. 31, 1982).

[75] Povell, *supra* note 41, at 16.

[76] *Id.*

[77] Where the Service reallocates income or expenses between related parties under § 482, and one of the parties has paid foreign taxes in respect of the income in question, the creditability of the foreign taxes often is affected. In Rev. Rul. 72-370, 1972-2 C.B. 437, a foreign subsidiary had paid foreign income tax. After that foreign tax had been paid, the Service made adjustments under § 482, reallocating certain income and expense items to the parent. Had those income and expense items been allocated to the domestic parent *ab initio*, the ruling posited, neither the foreign subsidiary nor the parent would have been liable for a portion of the foreign taxes actually paid by the foreign subsidiary. The ruling held that a foreign tax credit was not allowable to the parent for the portion of the foreign income tax that had been paid by the subsidiary upon the income that was reallocated to the parent under § 482, on the ground that the parent was not directly liable for the tax, and did not pay it or become subject to it. On the other hand, the Service ruled in a companion ruling that where foreign corporation A paid $100 of royalties to related foreign corporation B, from which it withheld $15 of foreign tax, and the Service later reallocated the royalties to the domestic parent of both corporations under § 482, the parent was allowed a foreign tax credit under § 901 for the amount ($10) of foreign tax that would have been withheld under applicable law. The tax was treated as having been paid by B on behalf of the domestic parent. Rev. Rul. 72-371, 1972-2 C.B. 438.

In Rev. Rul. 74-158, 1974-1 C.B. 182 and Rev. Rul. 72-508, 1976-2 C.B. 225, the Service illustrated the effect of a § 482 adjustment on the deemed-paid credit. Under the rulings, the accumulated profits amount and the amount of foreign tax used to compute the § 902 credit are to be recomputed by giving effect to the Service's § 482 adjustment. If the § 482 adjustment would decrease the foreign tax in question if the foreign government also gave effect to the adjustment, Rev. Rul. 76-508 holds that the foreign tax must be recomputed on that basis, and there is a presumption that the subsidiary has made a (noncreditable) contribution to the foreign government of the portion of the tax actually paid that is based

ity relief pursuant to the United States-Netherlands Antilles treaty might be available to resolve any resulting double taxation problem.

In supporting an *Aiken*-type conduit theory, which would essentially ignore the role played by the IFS in the overall financing arrangement, the agent relied upon the existence of the following factors:

1. the inadequate capitalization of the finance subsidiary;
2. the United States parent's guarantee of the finance subsidiary's debt;
3. the lack of earnings history of the finance subsidiary;
4. the fact that most of the finance subsidiary's initial assets were used to secure obligations of its United States parent and affiliates;
5. the finance subsidiary's lack of assets not involved in the loan transaction; and
6. the fact that the finance subsidiary had no office and incurred only nominal expenses.[78]

The consequences of the application of this theory are to deny to the United States parent corporation the chief benefit sought to be obtained via the Netherlands Antilles IFS borrowing technique, or the withholding tax exemption pursuant to the United States-Netherlands Antilles treaty on the interest payments made to foreign bondholders. In addition, the parent corporation may have to redeem the outstanding IFS bonds in question, and obtain refinancing at the higher rates of interest demanded in the domestic capital market.

Texas International Airlines, Inc. has not yet exhausted its administrative and judicial remedies.[79] While "[t]he history of these finance subsidiaries indicates that Texas International will be successful in its appeal,"[80] the consequences of an affirmance of the Houston district office agent's audit report are grave indeed. For Texas International is not alone in its audit difficulties with the IRS. "Present indications are that not less than five and perhaps a significantly larger number of international finance subsidiaries' situations are now the target of audit deficiency assertions."[81] In addition, it has been speculated that the Texas International subsidiaries "are similar to those of hundreds of other

---

> on the income reallocated from the subsidiary to the parent. This presumption can be rebutted if the subsidiary exhausts all effective and practicable remedies in seeking a refund of the foreign taxes, and if the domestic parent exhausts its rights under the competent authority procedure of any applicable treaty. An example of a settlement between a foreign subsidiary and the local tax authorities that rebutted this presumption is set forth in Rev. Rul. 77-267, 1977-2 C.B. 243.

Geen & Schreyer, *Foreign Tax Credit-Qualification and Computation,* 5 TAX MGMT. (BNA) at A-8 (4th ed. 1979) (footnote omitted).

[78] Povell, *supra* note 41, at 17.

[79] *See* 1982 DAILY TAX REP. (BNA) No. 169, at G-7 (Aug. 31, 1982); *Closing a Loophole*, *supra* note 73, at 1.

[80] DAILY TAX REP., *supra* note 79, at G-7.

[81] Povell, *supra* note 41, at i.

Eurodollar issues."[82] A "domino effect," triggered by a negative opinion against Texas International in its appeal, could result in the dislocation of billions of dollars of outstanding IFS debt obligations and "cause a total panic in the market."[83]

J. *Audit Prevention Techniques*

It is easy to conclude that in order to minimize the likelihood of an IRS attack upon its Eurodollar borrowing, a contemplated IFS should avoid all of the negative factors which were relied upon by the IRS in connection with the Texas International audit. In addition, an IFS would be well served by adhering to the following general guidelines:[84]

1. take all actions tending to formally evidence its separate corporate identity;
2. treat all of its assets and liabilities as its own;
3. engage in bona fide business activities;
4. maintain an appropriate debt-equity ratio;
5. make appropriate investments with its equity capital;
6. avoid making its equity capital available to its United States parent corporation or other United States affiliates (if this becomes absolutely necessary, the services of an intermediary foreign bank should be used to provide funds indirectly);
7. deal at arms-length with its United States parent corporation; and
8. avoid establishing a trade or business or permanent establishment in the United States.

V. Tax Avoidance Problems from the United States Treasury Standpoint

The definitive statement of the United States Treasury position concerning the use of IFS financing arrangements appears to be contained within a 1981 document which has come to be known as "The Gordon Report."[85] This report "was structured and its terminology chosen care-

---

[82] DAILY TAX REP., *supra* note 79, at G-7.

[83] *Id.*

[84] This list is not exhaustive. For further discussion of these and other general guidelines, see Povell, *supra* note 41, at 12-15.

[85] R. GORDON, TAX HAVENS AND THEIR USE BY UNITED STATES TAXPAYERS — AN OVERVIEW (1981). The cover letter accompanying the report, addressed to the Commissioner of Internal Revenue, the Assistant Attorney General (Tax Division), and the Assistant Secretary of the Treasury (Tax Policy), describes the genesis and purpose of the report as follows:

> You have asked that I review and advise you regarding the use of tax havens by United States persons and present options to be considered for dealing with problems created by that use.
>
> In response to your request, I am pleased to submit the enclosed report which is based on a study and analysis of tax haven transactions, United States internal tax laws applicable thereto, United States income tax treaties, and the attempts of the tax administrators to deal with these transactions.

fully in order to dramatize the need for corrective measures" within the existing tax haven regulatory framework.[86]

The report begins by generally defining tax haven jurisdictions as those which impose low rates of tax when compared with the United States, and afford a high level of bank and commercial secrecy which they refuse to breach even under an international agreement.[87] The report then describes the different types of activities carried on by tax haven entities. These activities are classified into three categories — legitimate, abusive, and evasive.

> Legitimate transactions include those that are purely economically motivated and those which, although tax motivated, do not violate the spirit or letter of the tax law. Abusive transactions include those which take advantage of some unintended loophole. Evasion is an action by which a taxpayer seeks to escape tax liability by fraudulent means.[88]

The report is naturally interested in curbing evasive and abusive transactions. Into these categories the report classifies:[89]

1. methods of structuring the stock ownership of a foreign corporation so that it will not constitute a Controlled Foreign Corporation under Subpart F of the Internal Revenue Code;[90]
2. the ownership of captive offshore insurance companies by small groups of United States shareholders;[91]
3. any arrangment which permits a nonresident of a tax haven to create a corporation in a tax haven which then proceeds to receive some form of passive income with a minimum imposition of tax;[92]
4. arrangements that allow tax haven corporations owned by United States persons to engage in active business transactions while avoiding the provisions of Subpart F;[93] and
5. arrangements designed to conceal and/or launder the proceeds

It is this author's view that many of the positions taken in the report have been adopted by the U.S. Treasury since its publication.

86 Franklin, *Tax Havens — Problems With Continued Use*, 40 INST. ON FED. TAX'N 33-1, 33-5 (1982).

87 R. GORDON, *supra* note 85, at 3.

88 Franklin, *supra* note 86, at 33-3.

89 *See id.* at 33-3 to 33-5.

90 *See supra* note 20 and accompanying text.

91 A discussion of captive offshore insurance companies is beyond the scope of this article. For a more detailed discussion of this topic, see O'Brien & Tung, *Captive Offshore Insurance Corporations*, 31 INST. ON FED. TAX'N 665 (1973).

92 The typical IFS financing arrangement discussed throughout this article falls into this category.

93 The I.R.S. has recently issued a technical advice memorandum which takes an aggressive position as to what constitutes Subpart F income. *See* I.R.S. Letter Ruling 8127017 (March 26, 1981) (Joint corporate officer of controlled foreign corporation (CFC) and its U.S. parent provides substantial assistance to the performing of services by the CFC for the parent, so that under I.R.C. § 954 (1976), income derived in connection with the performance of such services is Subpart F income).

of fraudulent or criminal activities.[94]

A. Recommendations

The report then recommends a coordinated attack on the use of tax havens in order to correct the above perceived abuses. The report recommends, first, improvement in the coordination and funding of the administrative effort to deal with tax haven problems; second, substantive changes in United States tax law; and third, changes in United States treaty policy.[95]

The principal administrative changes would be to modify existing regulations or rulings to:

1. require that books and records of CFCs be maintained in the United States;
2. improve guidelines under section 482 in order to ease administrative burdens placed on taxpayers and the Service and to achieve greater certainty in pricing international transactions;
3. require withholding of tax on all payments of U.S. source fixed or determinable annual or periodic income to foreign taxpayers and to provide for payment of a refund upon the foreign taxpayers filing of claim;
4. increase the taxpayer's burden of proof regarding proposed deficiencies involving tax haven-related issues; and
5. deal with certain specific areas of "abuse" such as loans negotiated by the domestic branch of a foreign bank but booked at such bank's foreign office.[96]

The principal legislative modifications suggested would:

1. amend Subpart F so as to tax all income of tax haven corporations controlled by United States taxpayers;
2. impose tax on all income of any foreign corporations managed and controlled in the United States;
3. expand the definition of a CFC by diluting the "more-than-fifty-percent" voting control test; and
4. impose a "no-fault" penalty on tax deficiencies relating to tax haven transactions.[97]

The principal modifications to the existing tax treaty structure would be to:

1. terminate treaties with certain tax havens such as the Netherlands Antilles;

---

[94] These types of arrangements are further explored in Blum, *Offshore Money Flows: A Large Dark Number*, 35 J. INT'L AFF. 69 (1981).

[95] *See* R. GORDON, *supra* note 85, at 10-13.

[96] Franklin, *supra* note 86, at 33-6 (footnotes omitted).

[97] *Id.* at 33-7 (footnotes omitted).

2. insert strong exchange of information provisions into existing and future treaties; and
3. insert into treaties provisions which prevent their use by so-called "third country" residents.[98]

B. Administrative Response

It is difficult to determine what projects are underway at the Treasury Department to implement the administrative changes listed above. Since the Government Accounting Office has recently recommended the revision of the section 482 regulations, some momentum may be building in favor of such a project.[99] The Treasury Department does not appear to favor the mandatory withholding-refund system. With that exception, however, the Treasury Department can be expected to strive for the implementation of all of the suggested reforms.

C. Legislative Response

It is easier to measure the progress that has been made toward implementation of the suggested legislative changes. Certain legislative projects are underway which could have a significant impact upon the use of IFS financing arrangements. The most significant legislative enactment since the publication of the Gordon Report has been the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[100] The key provision of the Act,[101] section 342, calls on the United States Treasury to issue regulations within two years "getting at the problem of unintended parties taking advantage of tax treaties that allow for foreign investors to avoid the thirty-percent withholding on interest."[102] The provision includes language requiring that a mandatory withholding system be considered, which the United States Treasury does not favor.[103] Significant

---

[98] *Id.* at 33-9 (footnotes omitted).

[99] *See id.* at 33-6 to 33-7.

[100] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 92-248, 96 Stat. 324 (codified as amended in scattered sections of 26 U.S.C.).

[101] An early version of TEFRA contained a provision which would have mandated the registration of all securities with maturities greater than one year held by foreign investors. Following a lobbying effort by the investment banking community, the provision "was sufficiently watered down so as not to really be an impediment at all." An exemption to the provision is now allowed "if the bonds are issued under 'arrangements reasonably designed to ensure that they will be sold or resold only to foreign persons.' "

1982 DAILY TAX REP. (BNA) No. 169, at G-6 (Aug. 31, 1982).

[102] 1982 DAILY TAX REP. (BNA) No. 194, at G-3 (Oct. 6, 1982).

[103] The following remarks by Assistant Treasury Secretary for Tax Policy John Chapoton, concerning a mandatory withholding-refund system, summarize the U.S. Treasury position as it stands currently:

> That idea has been proposed several times. We've concluded that it's not the best way to go, but we certainly don't mind reviewing it again. My offhand reaction, though, and I remember from my review of it, which was last year in connection with a specific treaty, we concluded that it was not wise. I don't really remember why now. Our policy decision is the negotiation of future treaties to prevent with very strong, workable anti-abuse provisions to prevent the type of thing he (Rep.

reasons include the possible negative impact on the flow of foreign capital into the United States due to the increased cost to foreign persons of losing the use of funds while tax is being withheld on their interest payments, the ability of United States treaty partners to obtain residency certification information, the possibility that these treaty partners would "retaliate" by instituting a withholding system of their own, and increased internal administrative burdens.[104]

The legislative provision with perhaps the most far-reaching potential is H.R. 3025, which would repeal the thirty-percent withholding tax on all foreign portfolio interest on foreign portfolio indebtedness. Originally introduced as H.R. 4618 by House Ways and Means Committee members Rep. Conable (R-N.Y.) and Rep. Gibbons (D-Fla.), and supported by the Reagan Administration in early 1982, this bill must overcome significant obstacles before it is enacted into law.[105]

The legislature has recently begun to consider a partial repeal of the withholding tax. A compromise plan which would reduce the withholding tax to about two and one-half percent is now pending in the Senate Finance Committee as part of certain "add-on" provisions suggested by its members for inclusion in Chairman Dole's (R-Kan.) deficit reduction package.[106] If treaty withholding rates were then adjusted to match the

---

> Rosenthal) is concerned about, and he's also concerned not only about the language of the treaty, but of the avoidance of the absolute language of the treaty. So far, I don't think we've been convinced that that's a serious enough a problem to take that dramatic a step. The point would be to actually change the provisions so that the witholding occurs and then the refund procedure comes in. That would mean obviously the loss of the capital to the parties and I just think that we have not been convinced that in any instance that this is such a dramatic problem.

1982 DAILY TAX REP. (BNA) No. 194, at G-3 (Oct. 6, 1982).

[104] *Id.* at G-2.

[105] Prior attempts to repeal the foreign withholding tax on foreign portfolio investments have been met with little support. The original Conable-Gibbons bill, H.R. 4618, 97th Cong., 2d Sess. (1982), died when the second session of the 97th Congress adjourned in late 1982. The bill has subsequently been reintroduced as H.R. 3025.

In addition,

> In connection with the Tax Reform Act of 1976, the House Ways and Means Committee reported a bill that included an elimination of withholding tax on both interest and dividends except where paid to controlled foreign corporations or where paid to 10 percent or greater shareholders by a U.S. person owned to the extent of more that 50 percent by non-U.S. persons. This was rejected by the House of Representatives. The Senate Finance Committee then reported a bill that included an exemption limited to interest, but this narrower exception was rejected by the Senate. On December 6, 1979, the Senate Finance Committee reported another bill (H.R. 2297) containing a provision repealing the 30 percent withholding tax on interest (including original issue discount) paid to nonresident aliens and foreign corporations.

Gelinas, *supra* note 2, at 235 n.19. H.R. 2297 died when the 96th Congress adjourned late in 1980.

Despite the lack of historical support for attempts to repeal the foreign withholding tax in this area, yet another bill has been introduced. H.R. 4029, 98th Cong., 1st Sess. (1983), introduced in late 1983 by Rep. Bernard (D-Ga), contains similar provisions. As of late January, 1984, the House had taken no action on either bill.

[106] 1983 DAILY TAX REP. (BNA) No. 249, at G-2 (Dec. 27, 1983).

new statutory withholding rate, passage of the new provision would go far to solve the "treaty shopping" problem as perceived by the Treasury.

D. *Treaty Policy Response*

The greatest possibility for rapid, dramatic change in the tax treatment of the IFS lies in the area of treaty policy, for without the presence of favorable tax treaties, IFS financing techniques would never have developed. In this realm, the United States Treasury can make policy relatively unencumbered by the legislative process.[107] Accordingly, the Treasury Department has recently initiated a bilateral attack upon the tax treaties it considers abusive: first, it has developed two new Model Treaty provisions designed to curb "treaty shopping" by third country residents; and second, it has undertaken to renegotiate certain tax treaties with the expectation that meaningful anti-abuse provisions will be included.

E. *Model Treaty Article 16*

Since the release of the Gordon Report, the United States Treasury has developed two distinct anti-treaty shopping provisions for use in tax treaties both old and new.[108] The first of these provisions constitutes Article 16 of the Treasury Department's June 16, 1981 version of the Model Income Tax Treaty, which reads as follows:

> Article 16
> Limitations on Benefits
>
> 1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless:
>
> (a) more than 75 percent of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and
>
> (b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a state other than a Contracting State and who are not residents of the United States.
>
> For the purposes of subparagraph (a), a company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State.
>
> 2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did

---

[107] The Senate, of course, must advise and consent to any treaty before it becomes effective. *See* U.S. CONST. art II, § 2, cl. 2.

[108] The 1976 and 1977 Model Income Tax Treaties also included anti-treaty shopping provisions. The U.S. Treasury is of the opinion that the two newest versions of the anti-treaty shopping article are superior to the former provisions, however, and it is not likely that the former provisions will be used in future treaty negotiations. *See* Freud, *Treaty Shopping and the 1981 U.S. Treasury Model Income Tax Treaty,* 1982 FOREIGN TAX PLANNING 37, 55 (1982). The anti-treaty shopping article from the 1977 Model Treaty is reprinted in *id.* at 48.

not have as a principal purpose obtaining benefits under the Convention.

3. Any relief from tax provided by a Contracting State to a resident of that other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other State, the income to which the relief relates bears significantly lower tax than similar income arising from within that other State derived by residents of that other State.[109]

This provision thus appears to be targeted directly at the use of IFS financing arrangements. In essence, the provision would deny treaty benefits to the typical Netherlands Antilles IFS assumed throughout this paper. Moreover, unfortunately, the Treasury Department has not seemed reluctant to insist on the inclusion of the article during the course of renegotiating existing tax treaties, for the article was the basis for the limitations on benefits clause, Article 17, introduced by protocol into the United States-Jamaica Income Tax Treaty.[110]

United States parent corporations which have either already established IFSs, or which are contemplating doing so, will justifiably be concerned over the Treasury Department's future treaty negotiation posture. In other words, they will want to know whether the Treasury will "settle" for any anti-treaty shopping provision other than the above Article 16 during the course of future treaty renegotiations, as an alternative to the outright termination of the treaty. This question may have been answered, at least in part, when the Treasury Department on December 28, 1981 issued a discussion draft of an alternative to the 1981 Model Income Tax Treaty Article 16, which provides as follows:[111]

Article 16
(discussion draft)
Limitations on Benefits

1. A corporation which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State with respect to an item of income, gains or profits unless the corporation establishes that:

(a) its stock of any class is listed on an approved stock exchange in a Contracting State, or that it is wholly owned, directly or through one or more corporations each of which is a resident of a Contracting State, by a corporation the stock of which any class is so listed; or

(b) it is not controlled by a person or persons who are not residents of a Contracting State, other than citizens of the United States; or

(c) it was not a principal purpose of the corporation or of the conduct of its business or of the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived to obtain any of such benefits.

---

[109] U.S. Treasury Dep't, Model Income Tax Treaty, art. 16, *reprinted in* 1 TAX TREATIES (CCH) ¶ 153 (1977).

[110] *See* Income Tax Protocol, July 17, 1981, United States-Jamaica, art. III, __ U.S.T. __, T.I.A.S. No. 10207. *See also* Freud, *supra* note 108, at 50, 61-63.

[111] U.S. Treasury Dep't, Discussion Draft of Article 16, Model Income Tax Treaty, *reprinted in* 1 TAX TREATIES (CCH) ¶ 152A (1982).

2. For the purposes of this Article:

(a) an approved stock exchange in ________________ means ________________;

(b) an approved stock exchange in the United States means the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934;

(c) a person or persons shall be treated as having control of a corporation if under the income tax laws of the Contracting State in which the income arises the person or persons could be treated as having direct or indirect control of the corporation for any purpose;

(d) notwithstanding subparagraph (c) of this paragraph, a corporation is presumed to meet the requirements of subparagraph (b) of paragraph 1 of this Article if the corporation establishes that individuals who are:

(i) citizens of the United States;

(ii) residents of a Contracting State; or

(iii) residents of States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention; own directly more than 75 percent of the total combined voting power of all classes of the corporation's stock entitled to vote and more than 75 percent of the number of shares of each other class of the corporation's stock;

(e) a corporation is presumed to meet the requirements of subparagraph (c) of paragraph 1 of this Article, in particular, where:

(i) the reduction in tax claimed is not greater than the tax actually imposed by the Contracting State of which the corporation is resident; or

(ii) the corporation is engaged in business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income which is incidental to or derived in connection with such business.

One writer has described this version of Article 16 as follows:

> The discussion draft appears less restrictive than the 1981 draft Model Treaty provision, in that the discussion draft applies only to corporations, rather than to "persons," which would include other entities, such as trusts and partnerships, and in that listing *any* class of stock on a recognized exchange would suffice in aiding exemption from the application of the discussion draft provision. It should also be noted that the discussion draft provision does not apply to losses and sets forth objective tests for determining whether a corporation is established for purposes of treaty shopping, which appear slightly more liberal than those set forth in the United States Income Tax Treaty with Jamaica.[112]

It appears, then, that the Treasury Department is willing to "settle" for an anti-treaty shopping provision less stringent than the 1981 Model Income Tax Treaty Article 16. Indeed, it seems that discussion draft Article 16 was written with the express purpose of permitting the use of IFS financing arrangements of the type contemplated in this paper to

[112] Freud, *supra* note 108, at 54.

continue without significant modification, if any. One pair of writers has even gone so far as to state that "[i]t is readily apparent that the Treasury Department is not concerned with abuse of tax treaties by subsidiaries of U.S. public companies."[113] It then remains to be seen whether the rationale behind discussion draft Article 16 represents a shift in policy from the standpoint of the United States Treasury, and what effect the provision will have upon future treaty negotiations.

F. Current Treaty Negotiations — The Netherlands Antilles

The recent flurry of treaty negotiation activity may be reflective of an evolving Treasury Department policy concerning the availability of treaty benefits through the use of existing treaties with so-called "tax haven" entities.[114] The United States-Netherlands Antilles treaty has been

---

[113] Ruchelman & Imamura, *Treaty Shopping: Proposed Article 16 of the United States Model Income Tax Treaty*, 9 TAX PLAN. INT'L. 3 (1982).

[114] Current examples reflecting this evolving policy include negotiations with Jamaica, the British Virgin Islands, Antigua, Guam, and Barbados.

Jamaica. As indicated *supra*, the anti-treaty shopping article of the United States-Jamaica treaty was, in 1981, replaced by an article similar to article 16 of the 1981 Model Income Tax Treaty. *See supra* note 110 and accompanying text. The adoption of this provision indicates an aggressive Treasury Department bargaining posture, and a conciliatory Jamaican posture. The new article virtually ensures that Jamaica will not be used as an incorporation site for the typical IFS financing arrangement contemplated by this article. *See generally* Freud, *supra* note 108, at 50, 61-63.

British Virgin Islands. The United States-British Virgin Islands treaty was cancelled by the Treasury Department in July, 1982, after British Virgin Islands officials refused to accept a clause proposed by the United States which provided for a more open exchange of information between the two countries involving business transactions in the islands. A State Department spokesman explained that the British Virgin Islands "aren't being singled out . . . . This is simply the first in a methodical attempt to wipe out tax avoidance by foreign investors." Wall St. J., Oct. 11, 1982, at 1.

Antigua. Antigua terminated its income tax treaty with the United States, effective April 5, 1983. The treaty was virtually identical to the previously cancelled United States-British Virgin Islands treaty. One reason for Antigua's cancellation of the treaty is its desire to capture a larger share of the international financial and trading operations that have been lured to other Caribbean islands:

> [S]ources close to the Antigua government said that island's parliament is expected to pass legislation within the next several weeks involving changes in its taxation, banking, trust, insurance, and shipping laws in order to attract businesses to the newly independent nation. The eventual conversion of the island into an off-shore financial center is designed to mirror the tax-free environment now present in the Cayman Islands, Bermuda, and the Bahamas.

1982 DAILY TAX REP. (BNA) No. 218, at G-3 (Nov. 10, 1982). But "[t]he cancellation of the treaty also could represent a feeling by island officials that the posture being taken by the U.S. against treaty shopping . . . will scare business away from U.S. tax treaty partners." *Id.*

Guam. Guam is a U.S. possession, and therefore has no tax treaty with the United States. Under Guam's mirror internal revenue code, however, interest received by a Guam (or Virgin Islands) corporation which derives most of its income from outside the possession is exempt from withholding tax. *See* 1983 DAILY TAX REP. (BNA) No. 10, at G-3 (1983). This provision has apparently turned Guam into a legitimate alternative as an IFS incorporation site. In response, the IRS has issued interim regulations and revenue rulings designed to negate this possibility. *See* T.D. 7865, 1983-2 I.R.B. 10; Rev. Rul. 83-9, 1983-2 I.R.B. 9 (applicable to Guam); Rev. Rul. 83-10, 1983-2 I.R.B. 10 (applicable to the Virgin Islands). In essence, these regulations and rulings consider income received by corporations in a possession to be U.S. source income if not taxed by the possession. Any such income would then be deemed a direct payment from a U.S.

in the process of renegotiation since September of 1982.[115] Negotiators from the two countries have met in several rounds of discussions, but have yet to reach a final agreement[116] on revisions to the treaty which may prove to have a profound effect on the availability of the IFS borrowing technique. Sources have indicated that "the areas where disagreement continues include the future of Eurodollar and other investment financing through the Antilles and the exchange of information relating to these investments between the Antilles government and the United States Treasury Department."[117]

But sources have also indicated that the Treasury Department has "offered a provision that would allow the subsidiaries of U.S. firms to continue to offer debt on the Eurodollar market through the Antilles."[118] It appears, then, that in exchange for its offer of discussion draft Article 16 or its substantial equivalent, the United States Treasury is demanding the inclusion of an exchange of information provision undoubtedly similar to the provision which was responsible for the termination of at least one prior treaty.[119] It also appears that Netherlands Antilles officials "are balking at the inclusion of such a provision in the existing tax treaty."[120]

One commentator has noted that "anonymity is a crucial requirement of the foreign investors who comprise the Eurobond market," and that IFS debt obligations which are issued in bearer form "in effect guarantee the foreign investors this anonymity."[121] While this form of argument was successful in defeating the early TEFRA provision which would have required the registration of all securities held by foreign investors with maturities of greater than one year, it does not appear that the Treasury Department will be as sympathetic as the United States Congress. Indeed, one Treasury Department official has remarked that Article 16 and related proposals "were not aimed at providing U.S. com-

---

entity, subjecting it to the statutory withholding tax. The government of Guam has called for the withdrawal of these provisions, arguing that they have placed it "at a marked disadvantage in attracting foreign investment." 1983 DAILY TAX REP. (BNA) No. 10, at G-3 (Jan. 14, 1983).

Barbados. A previous treaty between the United States and Barbados, which was the result of a 1959 extention of the then-existing treaty between the United States and the United Kingdom, was terminated by the United States, effective January 1, 1984. However, American and Barbadian officials plan to formally open new income tax treaty talks during the week of February 13, 1984. The talks will take into account the model income tax treaties published by both the Organization for Economic Cooperation and Development (OECD) and the United States Treasury, to the extent necessary to reflect Barbados' status as a development country. 1984 DAILY TAX REP. (BNA) No. 7, at G-11 (Jan. 12, 1984).

[115] *See* 1982 DAILY TAX REP. (BNA) No. 169, at G-7 (Aug. 31, 1982).

[116] Negotiators have expressed optimism that a renegotiated tax treaty between the two countries will be completed in early 1984, thus continuing Netherlands Antilles access for U.S. firms to the Eurobond market without the necessity of withholding tax. *See* 1983 DAILY TAX REP. (BNA) No. 249, at G-1 (Dec. 27., 1983).

[117] 1982 DAILY TAX REP. (BNA) No. 208, at G-3 (Nov. 27, 1982).

[118] *See* 1982 DAILY TAX REP. (BNA) No. 218, at G-3 (Nov. 10, 1982).

[119] *See supra* note 114 (discussion of British Virgin Islands treaty).

[120] 1982 DAILY TAX REP. (BNA) No. 218, at G-3 (Nov. 10, 1982).

[121] 1982 DAILY TAX REP. (BNA) No. 169, at G-3 (Aug. 31, 1982).

panies with access to the Eurodollar market."[122]

A provision which would require the Netherlands Antilles to verify the identities of foreign lenders receiving tax-free interest would lessen the desirability of borrowing funds through the islands because the bearer bond status of the debt obligations would effectively be negated. Accordingly, irreparable harm to the Netherlands Antilles economy has been predicted if the exchange of information provision sought by the United States Treasury is included in the United States-Netherlands Antilles treaty.[123] It should be clear that an IFS will choose as an incorporation site a location not subject to such an exchange of information requirement if to do so will be in the best interests of its foreign bondholders. It is for this reason that the jurisdictions with existing tax treaties with the United States have argued so strenuously against this type of provision.

"Closing the Antilles window" could have a significant economic impact within the United States as well. Netherlands Antilles officials have understandably predicted severe consequences.[124] Possible consequences could be as severe as bankruptcy for United States parent corporations unable to refinance the debt obligations of their IFSs either quickly enough or on terms which are as advantageous. The more probable result, however, is that affected United States parent corporations will be forced to borrow in the domestic capital markets, thus incurring greater costs. In addition, the flood of billions of dollars worth of borrowing demand into capital markets in the United States will exert significant upward pressure on domestic interest rates.

It is perhaps cognizance of the potential harm that may result that keeps the current treaty negotiations moving forward. Negotiations with other treaty countries that have broken down have resulted in terminated treaties. The Treasury Department has, however, itself acknowledged that the "Netherlands Antilles has come to play a special role in international financial transactions."[125] There may, then, be some validity to the "herd theory" as expressed by one recent commentator:

> The notion is that, with billions in investment channeled through the Antilles, the United States will not dare to "pull the plug" through administrative action. Moreover, in a curious twist on normal negotiating postures, the size of "Antilles investment in the United States is thought to represent leverage for the Antilles in treaty negotiations.[126]

Perhaps this potential leverage will ensure a United States-Netherlands Antilles tax treaty satisfactory to all concerned parties.

---

[122] 1982 DAILY TAX REP. (BNA) No. 95, at G-6 (May 17, 1982).

[123] "Sources close to the current negotiations said the Antilles could lose about 3,000 jobs as a result of the drop in business activities caused by the information exchange provision." 1982 DAILY TAX REP. (BNA) No. 218, at G-3 (Nov. 10, 1982).

[124] *See* Wall St. J., Oct. 11, 1982, at 1.

[125] 1980 DAILY TAX REP. (BNA) No. 119, at G-4 (June 18, 1980).

[126] Rosenbloom, *U.S.-Netherlands Antilles Negotiations*; 9 TAX PLAN. INT'L 14, 16 (1982).

VI. Conclusion

It may be true that "[t]he finance companies represent the only escape from an unrealistic withholding tax on interest paid to nonresident aliens."[127] Government statistics revealed in 1979 that because of statutory and treaty exemptions, the withholding tax netted only about twenty-seven million dollars annually.[128] When the magnitude of this figure is compared to the costs incurred annually in order to avoid the withholding tax, retention of the tax hardly seems economically justifiable.[129]

Retention of the tax may be justifiable, however, for non-economic reasons. Arguments which have been made against the repeal of the withholding tax include: (1) the only additional investment the United States would attract from the repeal of the tax would derive from the class of international tax avoiders who are not paying tax in their own countries; (2) the unilateral elimination of the tax by the United States would sacrifice important bargaining leverage in the negotiation of tax treaties; and (3) repeal of the tax would favor foreign investors to the relative detriment of United States investors.[130]

The political difficulties associated with the repeal of this statutory tax necessitate a fundamental policy analysis concerning the proper United States position with regard to the international flow of funds via tax treaties. If the United States truly desires an international economic community characterized by the free flow of investment capital, this desire should be reflected in the United States treaty network worldwide. Assuming that the United States treaty network should be retained because of its beneficial impact upon international investment, it then becomes necessary to determine what treaty provisions are required to create an equilibrium between all of the concerned parties to international financial transactions.

The use of 1981 Model Income Tax Treaty Article 16 is inconsistent with the free flow of international investment capital. Its provisions effectively negate the possibility of using an IFS financing arrangement of the type contemplated by this paper in a jurisdiction where it is in force.

The Treasury's discussion draft Article 16, while imperfect,[131] appears to be a more finely tuned anti-treaty shopping provision. It would

---

127 *Id.* at 16.

128 *See* Lederman, *supra* note 4, at 87 n.4.

129 The Committee on U.S. Activities of Foreign Taxpayers of the Tax Section of the New York Bar Association has issued a report supporting the complete elimination of U.S. withholding tax on interest and also proposing alternative limited exemptions. *See* Report of the Committee on U.S. Activities of Foreign Taxpayers on the Withholding of Tax on Interest Paid by U.S. Borrowers to Foreign Lenders (Sept. 11, 1979), *reprinted in* SELECTED RECENT REPORTS OF THE TAX SECTION OF THE N.Y. STATE BAR ASSOCIATION 257 (1979).

130 For futher discussion of these and other arguments, see Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151, 1283 (1981); S. SURREY, P. MCDANIEL, & J. PECHMAN, FEDERAL TAX REFORM OF 1976 139 (1976).

131 *See* Ruchelman and Imamura, *supra* note 113, at 3-5.

deter treaty shopping while at the same time permitting a limited category of IFSs to operate.

The most troublesome treaty provisions presently under discussion are those which would require the country in which an IFS is located to verify the residence of holders of obligations of IFSs. On its face, this requirement seems simple and proper enough. But at what cost? On the one hand, the United States Treasury has a legitimate desire to ensure compliance with United States tax treaties. On the other hand, stifled international investment and economic upheaval may result. The solution to this problem will be found only upon resolution of these two conflicting policy considerations.