THE UNITED STATES BORROWER IN THE EUROBOND MARKET—A LAWYER'S POINT OF VIEW

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In recent years there has been a marked growth in long-term financing in the Eurobond market, the major portion of which has been in the form of Eurodollars, that is, deposits held abroad in the form of U.S. dollars.[1] Moreover, by far the greatest part of this borrowing has been by U.S. companies. It has been estimated that in 1968 U.S. companies sold more than $2 billion of such securities.[2] This article discusses various aspects of such financing by U.S. companies from the point of view of a U.S. lawyer.

I

WHY?

Why does a company in the United States resort to long-term debt financing in Europe at an interest cost which generally has exceeded that then prevailing in the U.S. market? The first and primary reason has been to secure funds for overseas capital investment. Prior to January 1, 1968, many companies had resorted to this market in order to keep their dollar outflows within the guidelines prescribed by the former so-called "voluntary" investment restraint program. After that date, the promulgation of the mandatory Foreign Direct Investment Regulations (hereinafter called the "Regulations")[3] in substance compelled many companies to adopt a similar course. To a much lesser extent, other companies in the United States have resorted to the Eurobond market in order to use the proceeds in the United States because either the funds were not otherwise readily available to them or the disclosure requirements in the Eurobond market were less than those which would apply in the United States.

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[1] Of a current list of 181 issues of outstanding Eurobonds, 156 are expressed in U.S. dollars. BANCA COMMERCIALE ITALIANA, LIST OF INTERNATIONAL BONDS, July 24, 1969.

[2] Statement by Charles E. Fiero, Director, OFDI, before Subcommittee on International Exchange and Payments of the Joint Economic Committee, on Jan. 15, 1969. CCH BALANCE OF PAYMENTS REP. para. 9104 (1969). Note that Eurobond issues by U.S. companies in the first quarter of 1969 aggregated $395 million representing a decline from $556.5 million in the first quarter of 1968. On the other hand, total Eurobond issues in the first quarter of 1969 totaled $982.5 million, up from $705.9 million in the first quarter of 1968. Wall Street Journal, April 17, 1969, at 1, col. 6.

[3] 15 C.F.R. pt. 1000 (1969) (not codified as of this writing). These regulations are cited hereinafter as OFDI Reg. § ——, omitting from each section reference the prefix "1000" (*e.g.*, § 1000.306) which it will bear when published in the *Code of Federal Regulations*. References to the *1968 Federal Register* are omitted in the interests of space and in expectation of early codification.

A. Foreign Direct Investment Regulations; Borrowing for Foreign Investment

Because of the unfavorable balance of payments position of the United States at the end of 1967, President Johnson on January 1, 1968, promulgated Executive Order 11387 which authorized the Secretary of Commerce, in substance, to regulate investments by United States persons in those foreign business ventures in which they had or acquired a ten per cent interest in the voting securities, capital, or earnings. Pursuant to that authorization, the Secretary established the Office of Foreign Direct Investments (hereinafter called "OFDI") and promulgated the Regulations. The original form of the Regulations contained many imperfections, since they were prepared secretly, in considerable haste, and without adequate consultation with interested parties. During 1968, OFDI amended the Regulations into what is now a comprehensive and generally cohesive body of doctrine with its own unique set of concepts.[4] While this article does not purport to be about the Regulations themselves, the Regulations have not only promoted Eurobond financing by U.S. companies but have also given rise to, or compounded, various legal problems of such financing. It is, therefore, impossible currently to consider those problems without some understanding of certain of the basic concepts of the Regulations and their impact in connection with financing. Since the Regulations were in a state of flux during much of 1968, any discussion of them in this article will, unless otherwise indicated, be on the basis of such Regulations as in force at July 31, 1969.

The Regulations not only limit overseas capital investments by U.S. companies in their affiliates[5] but have also endeavored to channel those investments into certain areas of the world. To that end the Regulations divide the world into three scheduled areas: Schedule A, consisting of less developed countries; Schedule B, consisting of developed countries where the United States has a special interest in promoting investments, such as the United Kingdom and Japan; and Schedule C, consisting of other developed countries, primarily those of Western Europe.

The Regulations apply a limitation on positive direct investment in foreign affiliates which are ten per cent or more owned. Direct investment in a particular schedule is the algebraic sum of net transfers of capital (*i.e.*, generally speaking, investments in or by, or loans to or from, overseas affiliates in that schedule) and reinvested earnings of incorporated affiliates in that schedule (*i.e.*, earnings minus dividends).[6] Since both net transfers of capital and reinvested earnings can be either

[4] OFDI supplemented the Regulations by two Interpretative Analyses and Statements in General Bulletin No. 1, 33 Fed. Reg. 15158 (1968), and General Bulletin No. 2, 33 Fed. Reg. 15834 (1968) [hereinafter cited as GEN. BULL. No. 1 and GEN. BULL. No. 2, respectively].

[5] Companies with relatively smaller aggregate overseas direct investment may achieve more freedom under the Regulations by electing an alternate world-wide maximum investment allowable of $1,000,000. OFDI Reg. § 503.

[6] OFDI Reg. § 306.

positive or negative, it follows that direct investment in any year in a particular schedule may be positive or negative. The Regulations establish annual direct investment allowables in each schedule on the basis of a company's average investment experience in that schedule during the base years 1965 and 1966. In computing whether positive direct investment is allowed, generally negative direct investment may be offset by additional positive direct investment. Positive direct investment in Schedule A for each year is limited to 110 per cent of the average positive direct investment in affiliates in that schedule during the base period years. The annual permitted positive direct investment in Schedule B is sixty-five per cent of the average positive direct investment in that schedule in the base years. On the other hand, the limitation in Schedule C for positive direct investment is the lesser of thirty-five per cent of the average positive direct investment in Schedule C during the base period years or the same percentage of the average reinvested earnings during the years 1964 through 1966 in that schedule.[7] An alternative investment allowable may be elected under which the allowable for each schedule is thirty per cent of the previous year's earnings in such schedule.[8]

The net effect of the Regulations has been that any material investment in Schedule C, that is, basically continental Europe, is forbidden and there have been severe limitations on new investment in the other schedules except in the fortuitous circumstances that a particular company had substantial base period experience in those schedules. The Regulations do, however, provide one safety valve which throughout 1968 permitted continued direct capital investment by U.S. companies. The Regulations provide that the proceeds of long-term foreign borrowing which are employed in making transfers of capital may be deducted in computing net transfers of capital for the particular year.[9] Thus in simple terms, if a U.S. company wishes to invest $1,000,000 in an affiliate in, say, France, and uses the proceeds of long-term foreign borrowing to do so, its transfer of capital is $1,000,000 against which it may take a deduction of $1,000,000 and thus arrive at a zero net transfer of capital with respect to the transaction.

Needless to state, since most of the borrowings have been for the purpose of providing funds for investment, it is necessary that they should comply with the definition of long-term foreign borrowing which is contained in section 324 of the

[7] OFDI Reg. § 504(a). Certain latitude in moving historical investment allowables is permitted, in part, dependent on previous years earnings. See OFDI Reg. § 504(c).

[8] OFDI Reg. § 504(b).

[9] OFDI Reg. § 313(d)(1). Similarly, after a transfer of capital has actually been made, it is possible to allocate against such a transfer of capital the proceeds of long-term foreign borrowing and obtain a similar deduction. OFDI § 306(e). The rationale for the permitted offset of the proceeds of long-term foreign borrowings against direct investment is that the acquisition by a foreigner of a long-term obligation of a U.S. person is regarded as a capital inflow for U.S. balance of payments purposes. On the other hand, an investment by a U.S. company in its overseas affiliate is regarded as an outflow. The Regulations in effect permit netting one against the other.

Regulations.[10] Practically all, if not all, of the Eurobond issues for this purpose have been in the category of those which have an original maturity (*i.e.*, no mandatory prepayments) of at least three years and, at the time of the borrowing, the debt obligations would, if purchased by nationals or residents of the United States, be subject to the interest equalization tax.[11]

While the Regulations permit the deduction of the proceeds of long-term foreign borrowing in computing net transfers of capital, they also provide that the complete or partial satisfaction of long-term foreign borrowing the proceeds of which were expended in making, or allocated to, transfers of capital constitutes a transfer of capital.[12] Similarly, the satisfaction by a U.S. company of the debt of its foreign affiliate whether or not in response to a guarantee constitutes a transfer of capital,[13] even though the making of the guarantee does not.[14] This gave rise to the question of whether or not a lender could be assured that a U.S. borrower or guarantor would be authorized to repay the loan when it fell due. To provide assurance in this regard, the Regulations contain a general authorization permitting the payment of the loan by the U.S. borrower or guarantor, provided that at the time of making the loan it delivers to the Secretary of Commerce a certificate to the effect that it believes, on the basis of all facts and circumstances then existing, that either it will not make any transfers of capital in connection with the payment of the borrowing within seven years or that, if it does expect to make any transfers of capital in connection with such payment within the seven-year period, it also believes that such payment will be authorized, that is, will fall within its investment allowables (either on the basis of the investment allowables generally available to it under the Regulations or because it expects to have negative transfers of capital which can be offset against the payment).[15] At the time the payment is made under such general authorization, the U.S. company is charged with the resultant transfer of capital, which is allocated to the schedule in which the proceeds of the long-term

[10] Under OFDI Reg. § 324, a long-term foreign borrowing must have an original maturity of at least twelve months or be extendable at the option of the borrower for that period. In addition, it must fall within one of the following categories:

(1) the borrowing is from a foreign bank [including a foreign branch of a U.S. bank];

(2) the borrowing is from or is guaranteed by a foreign country or any agency thereof;

(3) the borrowing has an original maturity of at least three years and, at the time of the borrowing the obligations resulting therefrom would, if purchased by nationals or residents of the United States, be subject to Interest Equalization Tax; or

(4) the lender agrees in writing that, for a period of three years, it will not sell or otherwise transfer the obligation to (i) a resident or national of the United States (other than a foreign bank) or to a Canadian person or (ii) any person who the lender has reason to believe will sell or otherwise transfer the obligation to any such U.S. resident or national or Canadian person.

[11] INT. REV. CODE of 1954, §§ 4911-31.

[12] OFDI Reg. § 312(a)(7).

[13] OFDI Reg. § 312(a)(6).

[14] OFDI Reg. § 312(c)(7).

[15] OFDI Reg. § 1002(b).

foreign borrowing were utilized or to which they were allocated at the time of such payment.[16] This transfer of capital may, of course, be in excess of its investment allowables in that particular year since the payment is permitted because the certificate was filed, but in that case the transfer constitutes a "mortgage" against investment allowables for subsequent years until the transfer is completely offset.

Payment by a U.S. company of interest on its own obligations to foreign nationals does not constitute a transfer of capital.[17] On the other hand, if the borrowing is by a foreign affiliate of the U.S. company which, pursuant to a guarantee, pays the interest obligation of the affiliate, that is regarded as satisfaction of a debt obligation of the affiliate and thus constitutes a transfer of capital.[18]

Under the Regulations as originally promulgated, direct investment in Canada, which is regarded as part of Schedule B, was subject to limitation. Because of the broad scope of U.S. investment in Canada it was recognized that this caused a great hardship, and as a result of the close integration of the economies of the two countries the Regulations were amended to permit freedom of investment in Canada.[19] In the light of this freedom of investment, it was felt that loans from Canadians should not be included as part of the proceeds of long-term foreign borrowings which could be used to offset transfers of capital elsewhere, and the Regulations so provide.[20] For the purposes of this article, this is particularly relevant in the case of underwritings of Eurobond issues as described below.

B. Domestic Use of Foreign Borrowings

Some U.S. companies have resorted to the Eurobond market in order to raise money for use in the United States. While there are undoubtedly circumstances where this was done because funds were not otherwise available to the particular company in the United States, there are other instances where it was probably done because the borrowing company desired to use the proceeds in connection with an acquisition (by tender offer or otherwise) in the United States. If the borrowing company had sought to raise the money publicly in the United States, it would have had to file a registration statement under the Securities Act of 1933, as amended (hereinafter called the "Securities Act"), and may have been required to disclose either the name of the company which it proposed to acquire with the proceeds of the issue or sufficient information to permit it to be identified.[21] Since there are few mandatory

[16] OFDI Reg. §§ 312(a)(7), 1003.
[17] OFDI Reg. § 312(c)(8).
[18] GEN. BULL. No. 1, § B312(o)(3).
[19] OFDI Reg. § 1102.
[20] OFDI Reg. § 1106.
[21] See Securities Act Form S-1, Item 3. In certain instances it may be necessary to give financial information concerning the company which is to be acquired. SEC Securities Act Release No. 4950 (Feb. 20, 1969).

requirements as to disclosure in connection with Eurobond issues, this early disclosure of a proposed target for acquisition could be avoided in the European offering circular.[22]

II

BASIC MECHANICS

A. Currency of Account and Payment

The greatest portion of the Eurobond issues have been expressed in terms of U.S. dollars and are payable in that currency.[23] From the point of view of a U.S. company which is making a substantial borrowing overseas, this provides certainty as to the amount in U.S. dollars which it will be required to pay at maturity or for interest. Moreover, dollars are freely convertible into other currencies and can thus be widely utilized. Some U.S. companies (or their foreign affiliates) have also borrowed substantial amounts expressed in a European currency, such as German marks, because in a particular case it may thereby be possible to obtain a somewhat lesser rate of interest than that currently prevailing in the Eurodollar market. This is particularly useful if the borrowing is by an affiliate of a U.S. company which borrows locally for its own use. Presumably the greater part of the affiliate's earnings is in the currency of the place of borrowing, and it can use that currency to repay the borrowing. On the other hand, if the borrowing is by a U.S. company in a currency other than dollars (or in the case of a guarantee by a U.S. company of a borrowing by its foreign affiliate in such a currency), the U.S. company must take into account the fact that a devaluation of the dollar or a revaluation of the currency of payment will require the expenditure of more dollars to repay the loan.[24] Since, however, most Eurobond issues of U.S. companies have been expressed in terms of dollars, this article will, for purposes of convenience, limit its discussion to Eurodollar issues.

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[22] Eurobond offerings are generally made to banks, securities dealers, and other professional investors in Europe. In many countries on that continent, offerings so made are not regarded as the type of "public" offering which must comply with particular prospectus requirements. Generally speaking, however, the contents of offering circulars for Eurobond offerings by U.S. companies have been strongly influenced by the customary U.S. disclosure practices. Moreover, note that failure of a U.S. company to make adequate disclosure in its offering circular in connection with the sale of securities could give rise to liability pursuant to rule 10b-5 under the Securities Exchange Act of 1934, as amended.

[23] See note 1 *supra.*

[24] Recently some interest has been expressed in the expanded use of financing expressed in European Units of Account which are based on 17 European currencies. New York Times, April 1, 1969, at 63, col. 1. The value of such Units does not change unless parities are adjusted in all 17 currencies, and, in that case, the change is limited to the fluctuation of the most stable currency which has moved in the direction taken by a majority (or greater percentage) of the currencies. *See* Blondeel, *A New Form of International Financing: Loans in European Units of Account*, 64 COLUM. L. REV. 995 (1964). Thus far, U.S. companies have not had financings in such Units.

B. Issue Directly by a U.S. Company

Generally speaking, it is not practicable for most U.S. operating companies to have direct public issues of Eurodollar debentures. As indicated below, in most cases it is necessary for those issues to be sold to persons who are neither residents or nationals of the United States nor Canadians. In the absence of a treaty, interest paid on the obligations is subject to U.S. withholding tax, which (except in those cases where the holder of the obligation is in a position to take a credit against his own domestic income tax in respect of such withholding tax) constitutes a decrease in yield to the holder. Since the Eurodollar debentures are usually in bearer form, even if an appropriate treaty were available to a particular holder, it would be necessary for him to identify himself specially to the Internal Revenue Service in order to enjoy its advantages.

Furthermore, while the Securities and Exchange Commission (hereinafter called the "SEC") has indicated that, to further the U.S. balance of payments position, it would not take any action for failure to register securities of U.S. companies distributed abroad to foreign nationals where the distribution was effected in a manner which would result in the securities coming to rest abroad, it stated, in substance, that the prime consideration was whether the offering was "made under circumstances reasonably designed to preclude distribution or redistribution of the securities within, or to nationals of, the United States."[25] In the case of most Eurodollar issues, the circumstances relied on are that the underwriters have agreed that they will not offer or sell the debentures in the United States to residents or nationals of the United States and will cause each dealer to make a similar undertaking. Most counsel faced with this question have also taken some comfort from the fact that the debentures would be subject to payment of interest equalization tax if acquired by U.S. residents or nationals, which would tend to inhibit their acquisition by Americans in the secondary market. A U.S. company which desires to sell its Eurodollar debentures directly could, of course, cause its underwriters to make such an agreement, but the debentures, being those of a U.S. obligor, would not be subject to interest equalization tax. Lacking the economic deterrent of that tax, there would be no effective restraint on the flow of such debentures into the hands of Americans, and it might therefore be somewhat more difficult for a lawyer to give his opinion that registration of the debentures under the Securities Act was not required.

Moreover, the debentures so sold would not comply with the most used of the standards of section 324 of the Regulations defining long-term foreign borrowing, that is, an original maturity of at least three years and the applicability of interest

[25] SEC Securities Act Release No. 4708 (July 9, 1964). It is customary in the case of most Eurobond financings by U.S. companies to obtain a "no action" letter from the SEC.

equalization tax. Thus the proceeds of the direct public sale of the debentures would not be available under the Regulations for direct investment in foreign affiliates.

Accordingly, in the light of these limitations, in most cases a direct issuance by a U.S. company of Eurodollar debentures would be limited to those situations where they could be placed privately with a small group of recipients who for the purposes of the Securities Act would agree either to take them for investment or not to dispose of them for a period of years in the United States or to U.S. residents or nationals. Furthermore, if the persons receiving such debentures agreed in writing that for a period of three years they would not sell or transfer such debentures to a resident or a national of the United States or to a Canadian or to anyone which such person had reason to believe would sell or transfer the debentures to such U.S. resident or national or Canadian, such debentures could constitute long-term foreign borrowings under the Regulations. Thus, if a U.S. company were acquiring the stock of a foreign concern from one or two stockholders, it would be possible under suitable restrictive agreements to deliver to them debentures of such company. Under the Regulations, such acquisition could be regarded as having been accomplished with the proceeds of long-term foreign borrowing,[26] and presumably registration of such debentures would not be required under the Securities Act since they would not have been taken with a view to distribution. Note, however, that interest on such debentures would be subject to U.S. withholding tax unless the holders could take advantage of treaty benefits.

C. Financing Vehicle Companies

The existence of these problems gave rise to the use by U.S. companies of financing vehicle companies which could make public offerings of Eurobonds that would have the two essential characteristics that the interest thereon would be free from U.S. withholding tax in foreign hands (without resort to a treaty) and that, if acquired by a U.S. resident or national, the acquisition thereof would be subject to interest equalization tax. The vehicle companies can be organized under the laws of either one of a limited number of foreign jurisdictions or a state of the United States.

While a number of foreign jurisdictions do not impose withholding tax on interest paid to nonresidents (not engaged in trade or business or with a permanent establishment or other disqualifying activity in the jurisdiction), there are few which do not have some other impediment which would prevent their usage for the situs of a financing vehicle company. For instance, there may be a restrictive foreign exchange law which limits borrowing from foreigners or a substantial capital issuance tax on equity capital. Since for U.S. tax purposes it is necessary to maintain

[26] OFDI Reg. § 324(a)(4); GEN. BULL. No. 1, § B324(b).

a five-to-one debt-to-equity ratio in the vehicle company,[27] such a tax on the equity capital could result in a major cost factor in the case of a large issue.

As a result, the two most popular foreign jurisdictions for the organization of vehicle companies have been Luxembourg and the Netherlands Antilles. Luxembourg law provides a special type of company known as a "holding financial company" (*holding de financement*) which holds debt or equity interests in affiliates. Such a company is taxed at a very low rate in Luxembourg,[28] and the interest on its obligations is free from Luxembourg withholding tax when paid to nonresidents of Luxembourg. The Netherlands Antilles similarly does not collect withholding tax on interest paid to nonresidents, and its tax structure is also relatively beneficial.[29] Since both Luxembourg companies and Netherlands Antilles companies are foreign for U.S. purposes, the acquisition by the U.S. resident or national of an obligation of such company would in most cases[30] be subject to interest equalization tax.

Another popular type of financing vehicle has been the Delaware finance company. This is a subsidiary specially organized in a state of the United States (usually Delaware) for the sole purpose of investing in or lending to affiliates of its parent company. So long as eighty per cent of the income of such a company is derived from sources without the United States, interest paid on its stock or obligations to nonresidents of the United States is free from U.S. withholding tax.[31] Furthermore, since, although a domestic corporation, its purpose is to make such investments or loans, it is deemed to be "formed or availed of for the principal purpose of obtaining funds (directly or indirectly) for a foreign issuer or obligor" so

[27] If a sufficient debt-to-equity ratio is not maintained, the Internal Revenue Service might disregard the existence of the financing vehicle and treat its obligations for tax purposes as though they were issued by the parent company. Murphy Logging Co. v. Comm'r, 239 F. Supp. 794 (D. Ore. 1965), *rev'd*, 378 F.2d 222 (9th Cir. 1967). Thus, all such obligations would be subject to U.S. withholding tax. The five-to-one ratio which is generally adhered to in Eurobond financings represents the current unpublished policy of the Service in issuing rulings.

[28] It is understood that the special tax regime of Luxembourg applicable to holding companies would impose an initial tax of 0.32% of the paid-in value of the shares, and an 0.16% annual tax on the securities issued by such a company. Since those taxes are not imposed on the basis of income, they are not creditable against United States tax under INT. REV. CODE of 1954 § 902.

[29] The Netherlands Antilles imposes a maximum tax of 3% on interest received by holding companies. If this special tax rate is not elected, the maximum tax rate is 30%. It should be noted that since any proceeds loaned back to a United States company will constitute an investment in U.S. property under INT. REV. CODE of 1954 § 956 and thus taxable to the U.S. shareholder as a dividend as the finance company accumulates earnings and profits (or, if not so taxed, would probably constitute subpart F income), the choice of a foreign jurisdiction for a finance company should be made not with the idea of avoiding U.S. tax, but with the idea of avoiding tax in addition to U.S. tax.

[30] Unless the company constituted a "less developed country corporation" under INT. REV. CODE of 1954 § 4916.

[31] Under INT. REV. CODE of 1954 § 861, interest and dividends paid by domestic companies more than 80% of whose gross income is derived from foreign sources outside the United States are considered to be income from foreign sources. Since the only withholding requirement in the Code is imposed by §§ 1441 and 1442, which relate to U.S. income, no withholding on such income is required. For this purpose, original issue discount is treated as interest income.

its stock or obligations are subject to interest equalization tax if acquired by U.S. residents or nationals.[32]

As those three vehicle companies are the most widely used, this article will limit its discussion to such companies and, for purposes of convenience, will describe them respectively as "Luxembourg Companies," "Curaçao Companies," and "Delaware Finance Subsidiaries." Their relative advantages and disadvantages depend on the factual situation of the U.S. Company in respect of a particular financing and will be considered along with the other elements of a Eurobond public issue.

III

ELEMENTS OF A EUROBOND PUBLIC ISSUE; LEGAL AND PRACTICAL PROBLEMS

While it might be possible to list other characteristics which would be desirable from a selling point of view, the following are certainly among the elements which must be taken into account in planning such an issue:

(i) *Bearer Instruments.* Most Eurobonds are sold in the European market where there is a decided preference for bearer instruments with their ease of transfer and anonymity. Generally speaking, therefore, most public issues of Eurobonds provide only for debentures in bearer form with coupons attached. Where the debentures are payable in U.S. dollars, there is usually a principal paying agent in the United States and other paying agents at banks in a number of the major cities of Europe. Principal of and premium, if any, and interest on the debentures, if paid by the principal paying agent are paid in dollars in the United States or, if paid by a paying agent abroad, are paid by a dollar check drawn on a bank in the United States or by transfer to a dollar bank account maintained by the payee with a bank in the United States.

(ii) *No Withholding Tax on Debentures.* As indicated above, it is essential that there not be any withholding tax with respect to the debentures. The debentures customarily provide that the interest will be paid free of withholding tax of the place of issuance, and they generally also provide that, if a withholding tax should be imposed by the law of the jurisdiction of incorporation of the issuer, the issuer will pay additional interest to offset the tax and will also have the right to call the debentures at par or at a reduced premium. In this regard it should be noted that the obligation to pay interest free from withholding tax usually contains a qualification that it does not apply to holders who are subject to taxes of the place of issuance (and possibly of the jurisdiction of the guarantor) if imposed because of the activities, such as maintenance of a permanent establishment or nationality of such holders in that place or jurisdiction.

It should also be noted that a large proportion of the Eurobond issues provide

[32] INT. REV. CODE OF 1954 § 4912(b)(3).

for the payment of interest annually, rather than semiannually or quarterly.[33] Over the life of the issue, this can result in a substantial saving to the issuer.

(iii) *Guarantee of Parent Company*. Where a financing vehicle with few assets of its own is utilized as the issuer, it is necessary that there be a guarantee by the parent company of the obligations because the credit underlying the Eurobonds is that of the latter company.

Where a Delaware Finance Subsidiary is used for the financing, the parent and that subsidiary are regarded as one person for the purpose of the Regulations,[34] and, accordingly, only one certificate need be filed with respect to the borrowing and the guarantee. If a Luxembourg or Curaçao company is utilized, no certificate is required for the borrowing, but the parent company must file a certificate pursuant to section 1002 of the Regulations with respect to its guarantee. In either case, the substance of the two certificates is the same, that is, either that no payments will be made by the parent company (or the Delaware Finance Subsidiary) within seven years or if any such payments are made within seven years, they will not exceed the investment allowables of the U.S. parent.

The guarantee is usually endorsed on the face of the debenture and guarantees not only the principal and premium but also the payment of the interest as if made by the vehicle company, that is, free from withholding tax.

In some instances a financing vehicle may be used for a borrowing which will benefit more than one primary party, for instance, a joint venture. In that case there may be a joint and several guarantee. It is to be noted that if the guarantee is to be several, and not joint, a holder of a debenture seeking to enforce such a guarantee may be forced to sue each of the two guarantors in two separate jurisdictions in order to secure the benefits of the full guarantee. If resort is had to payment under the several guarantees, the holder could possibly be subject to varying withholding tax consequences in each of those two jurisdictions (depending on, for instance, whether he had a permanent establishment in a jurisdiction). If a trustee is involved in the issue of debentures, it is possible to have the guarantee run to the trustee for the benefit of the holders. Indeed, in issues by United Kingdom companies it is not unusual to provide that the sole party entitled to enforce the guarantee is the trustee. In that case, it would be possible for the several guarantors to agree to submit to suit by the trustee in one jurisdiction.

(iv) *Capitalization of a Financing Vehicle*. In order that the Internal Revenue Service will not disregard the separate existence of the financing vehicle, it is desirable that its debt to equity ratio should be approximately five-to-one. If a Delaware Finance Subsidiary is to be utilized as the financing vehicle, there is, from the point of view of the Regulations, no impediment to the parent company's providing equity capital by cash or by a transfer of stock or other property to such

[33] One hundred one out of the 181 issues referred to in note 1 *supra*.

[34] OFDI Reg. § 325.

of the principal purposes of the transaction is not avoidance of U.S. income taxes. The Service in its guidelines[40] has indicated that, with some minor exceptions, it will not issue such a ruling where stock is transferred to a foreign subsidiary. Even if it were possible to obtain such a ruling, several months might elapse before its issuance, which could unduly hamper the organization of the financing. Accordingly, as a practical matter, the stock of a foreign affiliate is generally not useful in providing equity capital for a Luxembourg[41] or Curaçao company unless there is little or no gain involved.

(v) *Long-Term Foreign Borrowing.* If the proceeds of the sale of the debentures are to be used for investment in affiliates abroad or to acquire new affiliates, the debentures should constitute "long-term foreign borrowing" under section 324 of the Regulations. The term "long-term foreign borrowing" refers to borrowing by the parent company and includes borrowing by a Delaware Finance Subsidiary, which for the purposes of the Regulations is regarded as the same person as the parent company. On the other hand, such term does not include borrowing by a foreign affiliate, and in order that the proceeds of an issue by a Curaçao company will generally obtain the proper "netting" against transfers of capital by the parent company, it is necessary that a Specific Authorization be obtained from OFDI.

The obtaining of such a Specific Authorization is not always necessary so that the proceeds of such borrowing can be utilized for foreign investment. For instance, if a Curaçao company is utilized as the financing vehicle, such company could relend the proceeds from the sale of the debentures to, say, an affiliate in Argentina. Both the Netherlands Antilles and Argentina are Schedule A countries under the schedular division of the Regulations, and it is possible to make the transfer from one foreign affiliate to another without a charge against the investment allowable of the parent company if the two affiliates are in the same schedule. On the other hand, a loan by the Curaçao company to an affiliate in Germany (Schedule C) would be regarded by the Regulations as a transfer of capital from the Curaçao company to the parent company (that is, a negative transfer of capital from Schedule A) and a further transfer of capital from the parent company to the German affiliate (that is, a positive transfer of capital to Schedule C).[42] In that case, in order to avoid a charge against its investment allowables, it would be necessary for the parent company to have the ability to deduct from the latter transfer of capital the amount of the proceeds of foreign borrowing employed.

Similarly, a loan by a Luxembourg company (Schedule C) to an English affiliate (Schedule B) would be regarded as a negative transfer of capital from Schedule C

[40] Rev. Proc. 68-23, § 3.02(1)(a)(iii), 1968-1 CUM. BULL. 823.

[41] Luxembourg law requires that a holding company must have some stock in the enterprise, and this requirement may be met by transfer to it of some parent company stock. Issuance of such stock to a Luxembourg company would require a Specific Authorization from OFDI which would probably subject it to a condition that the Luxembourg company would not dispose of the stock.

[42] OFDI Reg. § 505.

and a positive transfer of capital to Schedule B in the same amounts. The Regulations permit the free transfer "downstream" (from C to B to A) of the right to make investments[43] and, thus, the negative transfer of capital from Schedule C could be moved "downstream" to offset (and permit) the resultant positive transfer of capital to Schedule B. On the other hand, a repayment of the loan by the English affiliate to the Luxembourg company would constitute a negative transfer of capital from Schedule B and a positive transfer of capital to Schedule C. Since the Schedule B negative may not be moved "upstream" under the Regulations, it is necessary that the Specific Authorization obtained in connection with the utilization of the Luxembourg company should also permit such a repayment.

(vi) *Use of Issue Proceeds in the United States.* If the proceeds of a sale of the Eurodollar debentures are to be used for investment in the United States by the parent company, it is probably desirable to utilize a Curaçao company as the financing vehicle. If a Delaware Finance Subsidiary issued the debentures and reloaned the funds to the parent company for use in the United States, the payment by the parent company of interest on its debt to the Delaware Finance Subsidiary would constitute U.S.-source income. Since this could be a principal source of income of the Delaware Finance Subsidiary, it might find it difficult to maintain eighty per cent of its gross income from sources without the United States. On the other hand, if a foreign finance vehicle were utilized, this problem would probably not arise.

The tax treaty between Luxembourg and the United States does not apply to holding companies,[44] however, so that, if a Luxembourg company were utilized, the payment by the parent company of interest on its obligation to the Luxembourg company would be subject to a thirty per cent U.S. withholding tax. In order that the Luxembourg company would have sufficient funds for its operations, it would therefore be necessary for that obligation to bear a significantly higher rate of interest than that pertaining to the debentures issued by the Luxembourg company. On the other hand, under the current tax treaty between the United States and the Netherlands Antilles, payments from the U.S. parent company to the Curaçao company would be exempt from U.S. withholding tax if the Curaçao company has not elected the three per cent maximum tax rate on holding companies. Thus, its income would be subject to a thirty per cent tax rate in the Netherlands Antilles.[45]

A somewhat similar problem can arise if the proceeds of the debenture issue are to be utilized for investment in an overseas branch of the parent company. For instance, suppose the parent company wishes to finance a drilling operation which it is conducting in, say, Libya. If the proceeds of the debentures of a Delaware Finance Subsidiary are to be loaned by it for this purpose, the payment of interest

[43] OFDI Reg. § 504.

[44] Art. XV, Convention between United States and the Grand Duchy of Luxembourg with respect to Taxes on Income and Property, ratified Dec. 22, 1964.

[45] See notes 29 and 38 *supra*.

on such loan would be regarded as income from U.S. sources since the branch in Libya is part of the corporate entity of the U.S. parent.

(vii) *Vehicle to be Freed from Heavy Tax Burden.* If a financing vehicle is utilized, it must be organized in a jurisdiction in which the income tax structure does not materially add to the cost of financing. A Delaware Finance Subsidiary meets this test, and, as indicated above,[46] both Luxembourg and the Netherlands Antilles are relatively favorable in this regard. In addition, however, it is important that the laws of the jurisdiction of incorporation of the financing vehicle be such that, not only the interest which it pays to nonresident holders on its debentures is free from withholding tax, but when it relends the funds to affiliates of the parent company, interest paid by such affiliates to the vehicle company should not be subject to a burdensome withholding tax that cannot be recouped. This, in substance, means that the vehicle company should be organized in a jurisdiction which has favorable tax treaties with jurisdictions where the proceeds of the issue are to be used.[47] A Delaware Finance Subsidiary has the advantage of the wide panoply of tax treaties prevailing between the United States and most other industrial nations. Relending of the proceeds of the sale of debentures by the Delaware Finance Subsidiary to an overseas affiliate would therefore be in substantially the same legal position as a lending by the parent company directly. On the other hand, a Luxembourg company generally does not enjoy this wide freedom since its tax treaties do not cover Luxembourg holding companies in this regard. Thus, a relending by a Luxembourg company to an English affiliate would not result in any exemption or diminution of the British withholding tax applicable to the payments of interest by the English affiliate to the Luxembourg company. A Curaçao company may therefore be preferable to the Luxembourg company in this regard since the Netherlands Antilles has a somewhat more favorable group of treaties, but these are still not comparable to those in force for U.S. companies.[48]

In any particular case, it is necessary to examine the combination of relevant tax laws and treaties involved in order to achieve the optimum combination. As this can take considerable time, particularly if it is necessary to consult counsel in a number of jurisdictions, it is desirable to start such an investigation as early as possible when planning a Eurodollar offering.

(viii) *Vehicle Company to be Free from Burdensome Securities Laws.* As a matter of convenience and in order to expedite the organization of the financing, it is often desirable that the debentures not be subject to the Securities Act. As pointed

[46] See notes 28 and 29 *supra.*

[47] *Cf.* p. 185 *supra.*

[48] Moreover, where a Curaçao company desires to relend to an affiliate in a country with which the Netherlands Antilles does not have a favorable tax treaty, it may be possible for the Curaçao company to make a loan to its U.S. parent (thus taking advantage of the tax treaty with the United States) and have the U.S. company relend to such affiliate under an applicable treaty between the United States and the country of such affiliate.

out above, this is facilitated if the interest equalization tax be applicable to acquisitions of the debentures by U.S. residents or nationals. If the debentures are not subject to the Securities Act, then, even though issued by a Delaware Finance Subsidiary, any indenture under which they were issued would not have to comply with the requirements of the Trust Indenture Act of 1939, as amended.[49] This permits the omission of some rather complicated provisions (such as one relating to conflict of interest on part of trustee) that would otherwise be mandatory.

If a Delaware Finance Subsidiary is used, it may technically constitute an investment company under the Investment Company Act of 1940, as amended, because more than forty per cent of its assets will be invested in securities other than U.S. Government securities and securities of its majority-owned operating subsidiaries.[50] The issuance of securities and transactions by an investment company are closely regulated under that act, and it would be impractical, if not impossible, to operate a financing vehicle company thereunder. On the other hand, section 6(c) of the Investment Company Act grants broad exemptive powers to the SEC to exempt companies from any or all of the provisions thereof. Acting under such power the SEC has issued Investment Company Act rule 6c-1, which generally exempts domestic investment companies (*e.g.*, Delaware Finance Subsidiaries) which are used for the financing of European affiliates from the provisions of the Investment Company Act provided they meet certain specified conditions. Those conditions are as follows:

(1) with certain exceptions the parent company must be the issuer of a class of securities registered under the Securities Exchange Act of 1934, as amended;

(2) debt securities of the financing vehicle must be guaranteed by the parent company as to the payment of principal, interest, and premium, if any;

(3) any preferred stock of the financing vehicle held by the public must be nonvoting and guaranteed by the parent company as to the payment of dividends, payment of liquidation preferences, and payments to sinking fund;

(4) any public offering of the securities of the financing vehicle must be made pursuant to underwriting or distribution agreements prohibiting the offer or sale of such securities in the United States or to nationals or residents of the United States;

(5) any conversion right of securities of the financing vehicle must be into securities of the parent company and must not come into effect for six months from the date of issuance (or such shorter period as is approved by the Secretary of the Treasury);

(6) upon completion of the long-term investment program of the financing vehicle, at least eighty per cent of its assets, exclusive of U.S. Government securi-

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[49] 15 U.S.C. § 77aaa-77bbbb (1964).

[50] Investment Company Act § 3(a)(3), 15 U.S.C. § 80a-3 (1964).

ties and cash items, must consist of investments in or loans to foreign companies;

(7) at least ninety per cent of the assets of the financing vehicle, exclusive of U.S. Government securities and cash items and short-term investments in foreign government and commercial paper, must be invested in or loaned to companies at least ten per cent of the equity securities of which are owned, directly or indirectly, by the parent company, and any assets of the financing vehicle not invested in such companies must only be invested in or loaned to companies which are customers or suppliers of the parent company or a subsidiary of the parent company; and

(8) the financing vehicle must not deal or trade in securities.

There is a further condition that at the time of issuance the securities of the financing vehicle must be subject to the interest equalization tax (or another comparable tax). If those conditions are not complied with, of course it would be necessary to obtain a special exemptive order from the SEC. This can be mechanically burdensome and time-consuming. Therefore it is preferable, if possible, to remain within the provisions of Rule 6c-1.

Neither Luxembourg nor the Netherlands Antilles has any burdensome securities laws. Any debentures issued by a Luxembourg or Curaçao company should be issued under conditions whereby it is agreed that the underwriters will not offer them in the United States or to residents or nationals of the United States. Furthermore, such debentures are subject to interest equalization tax so that it is possible to give an opinion and obtain a "no action" letter from the SEC to the effect that the debentures are not subject to the Securities Act and that any indenture under which they are issued is not subject to the Trust Indenture Act of 1939. Under those circumstances, it is also possible to give an opinion and to obtain a "no action" letter from the SEC to the effect that the Luxembourg or Curaçao company, as the case may be, does not constitute an investment company under the Investment Company Act.

(ix) *Market.* The total issue of the debentures usually should be great enough to permit the creation of a secondary market for such debentures. For this reason, it is frequently necessary for a company to sell a larger principal amount of debentures than it immediately needs for investment purposes. For instance, assume a U.S. company has immediate needs for $3,000,000 but expects in due course to have long-term requirements for additional offshore investment capital. Under those circumstances, in order to satisfy purchasers that there will be a sufficient volume of the debentures to create a secondary market where they can be resold, it may be desirable to sell at the outset, say, $10,000,000 or $15,000,000 aggregate principal amount of such debentures. Moreover, the expenses of the preparation and offering of a public

issue of under, say, $10,000,000, are proportionately great as compared with a larger issue.[51]

So that there can be a ready market, it is generally important that the debentures be listed on at least one stock exchange. Moreover, some purchasers are limited to purchasing listed securities. A large proportion of Eurobond issues are listed on the Luxembourg Stock Exchange because of the relative ease with which that may be accomplished. Issues are also listed on a number of other exchanges, and many, particularly the convertible issues of U.S. companies, seek listing on the New York Stock Exchange. This last listing, of course, requires registration of the debentures under section 12 of the Exchange Act, but this is not an onerous requirement.

(x) *Applicability of Interest Equalization Tax.* As indicated throughout this article, it is important in many respects that the interest equalization tax, and its implied deterrence, be applicable to the acquisition by a resident or national of the United States of the obligations of the financing vehicle. Under normal circumstances, this is clear if a Luxembourg or Curaçao company is utilized as such a vehicle. In the case of a Delaware Finance Subsidiary, it must be "formed or availed of for the principal purpose of obtaining funds . . . for a foreign issuer or obligor."[52] If it is desired to use the proceeds of the debenture issue to acquire all the stock of, say, a German company from its stockholders, it has been questioned whether the Delaware Finance Subsidiary has been formed or availed of for the principal purpose of obtaining funds "for a foreign issuer or obligor." It could be argued that the Delaware Finance Subsidiary was formed or availed of for providing funds to the selling stockholders. Nevertheless, the Internal Revenue Service has in rulings taken the position that the Delaware Finance Subsidiary is, under such circumstances, formed or availed of for the purpose of providing funds for a foreign issuer or obligor so that the interest equalization tax is applicable to the sale of its securities.

If all the proceeds of the borrowing are to be utilized in less developed countries, it is probable that the interest equalization tax would not apply[53] since that tax does not apply to the sale of securities of less developed country corporations. This would seem to be so whether a Luxembourg or a Curaçao company or a Delaware Finance Subsidiary were utilized. If the proceeds were to be divided among a number of investments, including both less developed country corporations and other foreign affiliates, presumably some portion of interest equalization tax would probably be applicable to the securities of the financing vehicle. Nevertheless, the recent reduction in the rate of the interest equalization tax,[54] which was happily received by all concerned, does raise the question as to the position that will be taken by various governmental agencies if the rate of such tax becomes such that it is not

[51] Of the 156 issues, expressed in U.S. dollars, referred to in note 1, *supra*, ten had an original aggregate principal amount of $10,000,000 and only one had a lesser original principal amount, *i.e.*, $8,500,000.

[52] See note 32 *supra*.

[53] INT. REV. CODE of 1954 § 4916.

[54] Exec. Order 11,464, 34 Fed. Reg. 6233 (1969).

regarded as an adequate deterrent with respect to the acquisition of the securities by United States residents or nationals. It is to be noted that Rule 6c-1 under the Investment Company Act provides that a Delaware Finance Subsidiary will not issue, without an order of the SEC, any securities in the event that the interest equalization tax expires or is repealed or the rate thereof is reduced to zero.[55]

(xi) *Temporary Investment of Proceeds.* Since it is seldom intended that all the proceeds of a public issue of Eurobonds will be utilized immediately, it is necessary that some interim usage be made of such proceeds pending their final investment in foreign affiliates or otherwise. Good business judgment would dictate that they be invested in some form of security or bank deposit which would generate earnings. Furthermore, when an application for a ruling is made on behalf of a Delaware Finance Subsidiary to the Internal Revenue Service with respect to the applicability of the interest equalization tax, it is usually represented that such Subsidiary will over the life of the issue generate enough earnings to pay the carrying charges on its debentures. Because the Delaware Finance Subsidiary must have more than eighty per cent of its income from sources without the United States, that has meant that the excess funds would generally be invested in short-term foreign securities or placed on deposit with foreign banks (including foreign branches of U.S. banks). If an attempt were made to invest such funds in long-term (*i.e.*, more than twelve months) securities, the interest equalization tax would be applicable thereto, if the issuer of such securities were a foreign person. As set forth above, rule 6c-1 under the Investment Company Act contemplates such short-term investment by a Delaware Finance Subsidiary by providing as one of the conditions that ninety per cent of the assets of such Subsidiary (except U.S. Government securities, cash items, and short-term foreign securities) must be invested in affiliates in which the parent company had a ten per cent interest or in customers of the parent company or such affiliates.

Unfortunately, this rather tidy arrangement was disrupted by the advent of the Regulations in 1968. Section 203 of the Regulations provides that a U.S. direct investor (including for the purposes of this discussion a U.S. parent company together with its Delaware Finance Subsidiary) will at the end of each month reduce its liquid foreign balances (other than "available proceeds") to an amount not in excess of the average end-of-month amounts held abroad by the direct investor during 1965 and 1966. Liquid foreign balances are, generally speaking, all bank deposits and short-term obligations having a maturity of less than one year from the date of deposit or acquisition. "Available proceeds" means the proceeds of long term foreign borrowing less amounts which have been expended in transfers of capital to foreign affiliates (other than Canadian affiliates) and amounts allocated to positive direct investment.

[55] Investment Company Act, rule 6c-1(c)(2), 17 C.F.R. § 240.6c-1(c)(2) (1968).

Note that there are two ways that the proceeds of long term foreign borrowing can cease to be available proceeds. The first is an actual expenditure of funds to a foreign affiliate (other than a Canadian affiliate) in respect of which the direct investor has deducted the amount of proceeds utilized from the transfer of capital involved. In such a case, no problem arises as to the retention of short term balances overseas since the funds involved are actually used. The second, however, is an allocation of the proceeds of borrowing which is merely a bookkeeping entry. The use of such an allocation can be illustrated as follows: suppose a U.S. company has a subsidiary in Ireland from which there should be a repatriation of dividends of $2,000,000 in order to comply with the limitations of the Regulations. Suppose, however, that the Irish company has been operating under a special tax incentive arrangement whereby it is paying little or no Irish income taxes. The dividend to the U.S. parent company would thus be taxable at full U.S. rates with no offsetting tax credits. If a Delaware Finance Subsidiary of a U.S. company had, say, $10,000,000 of "available proceeds" of long term foreign borrowings held in the form of short term certificates of deposit of a London branch of a U.S. bank, the U.S. company could, pursuant to section 306(e) of the Regulations, allocate $2,000,000 of the available proceeds to positive direct investment under Schedule B (which includes Ireland). This $2,000,000 could be deducted from such positive direct investment and would thereby permit the retention by the Irish subsidiary of the $2,000,000 otherwise required to be paid as a dividend. Thus far, no cash has been moved or transferred. The Regulations, however, are drafted with an intent that the U.S. balance of payments position would not be deprived of the inflow of such $2,000,000 under those circumstances. Accordingly, the U.S. company, in order to take such deduction, may not hold the proceeds as of the end of the year for which the deduction is made, directly or indirectly in the form of foreign balances or in the form of securities of foreign nationals or in the form of any other foreign property. In other words, the $2,000,000 of the cash proceeds of the long term foreign borrowing (as distinguished from the credit for the borrowing) must be repatriated to the United States. Moreover, the U.S. company is thereafter prohibited from holding such proceeds outside the United States in any manner described above. It may, however, use such proceeds to make a transfer of capital to a foreign affiliate, but would not be entitled to any deduction from the resultant charge against its investment allowables because the proceeds no longer constitute available proceeds and are treated as though they were any other domestic funds. Note, however, that the $2,000,000 could, on January 2 of the next succeeding year without any effect under the Regulations, be expended in making a transfer of capital to a Canadian affiliate of a U.S. company because there is no restriction on the making of transfers of capital to Canada.[56]

[56] OFDI Reg. § 1102.

Thus, if there were nothing more in the Regulations, a Delaware Finance Subsidiary could avoid difficulties in retaining overseas its unused proceeds of long term foreign borrowing by simply not allocating against positive direct investment. Unfortunately, the Regulations do not stop at this point. They provide that a direct investor which holds available proceeds in the form of foreign balances or in the form of securities of foreign nationals (including available proceeds actually expended in Canadian affiliates prior to any deduction with respect thereto under the Regulations) or in the form of any other foreign property as of the end of any year shall be prohibited from making a positive net transfer of capital to any scheduled area for such year.[57] This, in substance, means that so long as the direct investor has available proceeds held abroad, it does not have any investment allowables which it may use. Thus, it must use its proceeds of long-term foreign borrowing for all transfers of capital during the same year whether or not those proceeds were acquired after the transfer was actually made.

For instance, suppose a U.S. company had a historic investment allowable of $2,000,000 in Schedule A and loaned $1,500,000 pursuant to such allowable to an affiliate in Venezuela (Schedule A) in March 1969. Suppose further that in September 1969 its Delaware Finance Subsidiary sold $10,000,000 principal amount of Eurodollar debentures, all the proceeds of which were held as short term investment abroad. Pursuant to the Regulations the investment of $1,500,000 made the previous March would not remain authorized under its historic allowable, and it would be necessary for the company to allocate on its books $1,500,000 of the proceeds of the Eurodollar issue. It would, pursuant to the Regulations, be entitled to deduct from its transfer of capital to Schedule A the amount of the proceeds so allocated with the result that its net transfer of capital for the year 1969 to Schedule A would be zero and it would carry over into 1970 its unused historical investment allowable of $2,000,000. This would also mean, however, that its available proceeds of capital would be reduced from $10,000,000 to $8,500,000. It would also be required to repatriate to the United States $1,500,000. If that amount were invested in the United States, the earnings thereon could impair the "80-20" status of its Delaware Finance Subsidiary.

One acceptable alternative would be to make investments in short-term securities of a Puerto Rican issuer or in short-term certificates of deposit of a bank in Puerto Rico or a branch in Puerto Rico of a U.S. bank. For the purposes of the Regulations, Puerto Rico and the other U.S. territories and possessions are regarded as part of the United States[58] so that investment of the $1,500,000 in Puerto Rico would be regarded as repatriation of the liquid foreign balance. On the other hand, for the

[57] This prohibition does not apply to direct investors which have elected to be governed by the maximum $1,000,000 world-wide investment allowable.

[58] OFDI Reg. § 318.

purposes of section 861 of the Internal Revenue Code, the interest earned in Puerto Rico would be regarded as foreign source income.

The possibility permitted by section 861 of the Internal Revenue Code of investing in municipal bonds is not a desirable one. Although this would comply with the Regulations, under section 861 it would be excluded from all computation in connection with the "80-20" test and would therefore be excluded from both the numerator and the denominator of the calculation. Furthermore, it would probably not fall within the limitation in rule 6c-1 of U.S. Government securities, cash items, or short-term foreign securities. In addition, since interest on municipal bonds is tax-exempt, and under section 265 of the Code it is provided that no deduction is allowed for income tax purposes of interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations, there could be a question as to the deductibility of the interest on the related portion of Eurobonds.

A further possibility would be to make use of a Canadian affiliate. Thus, the allocation which would be required by section 203(d)(1) of the Regulations could be deferred until, say, December 31, and the proceeds could continue to be held in short term foreign investments until that date. On December 31, the $1,500,000 would be repatriated to the United States and held there at the end of the calendar year. Such $1,500,000 could not thereafter be transferred out of the United States except as a transfer of capital to a foreign affiliate. As indicated above, the transfer of capital to say, a French affiliate, could be made, but would be charged against the Schedule C investment allowables of the direct investor. On the other hand, an investment in a Canadian affiliate would also be permitted, but would not result in any charge against investment allowables.

This last route would not solve the problem for a direct investor which did not have a Canadian affiliate (or at least did not have any reason to form one). The only hope that the Regulations offer in this case is that if there were substantial hardship, an application for a specific exemption could be made to the Office of Foreign Direct Investment for relief. The grounds for making such an application would be that the return of the proceeds to the United States would contravene express representations made by the direct investor, or restrictions imposed thereon by persons from whom the relevant long term foreign borrowings were obtained (as conditions to obtaining such borrowings),[59] or would create a substantial probability of material adverse U.S. or foreign tax consequences to the direct investor.

It is submitted that the forced repatriation of available proceeds held by a Delaware Finance Subsidiary should be eliminated from the Regulations. In many cases its principal effect in the past has been to force the transfer of such

[59] It may be desirable to insert such a representation or restriction in the underwriting agreements for Eurobond offerings of Delaware Finance Subsidiaries.

proceeds to Canada and presumably that pattern will continue in a somewhat different form. At a minimum, the retroactive effect of the Regulation which, in substance, invalidates previously authorized transfers of capital because of a subsequent foreign borrowing should be eliminated. It must be realized that it has been an advantage to the United States to have the Eurodollar market available for borrowing by a U.S. company. The deposit of the proceeds of such borrowing abroad has supported this market. The recent drawing on such market by U.S. banks, which has severely curtailed the availability of Eurodollars, illustrates that repatriation of Eurodollars can limit the ability of U.S. companies to borrow abroad.[60]

If a Luxembourg or Curaçao company is utilized as the financing vehicle, the problem of the holding of the proceeds of the borrowing is not as severe. OFDI in past Specific Authorizations relating to foreign financing vehicles has inserted the condition that, for the purposes of section 203 of the Regulations, the parent company and the foreign financing vehicle must be regarded as one and the same company. Thus, the limitations on the holding of the proceeds of a foreign borrowing in short term foreign securities has been extended to the foreign financing vehicles. It is not clear what position OFDI will take with respect to such vehicle companies under the new terminology of restrictions on the holding of "available proceeds." It is submitted, however, that, under the current balance of payments reporting methods, there may be some question as to whether the United States will obtain any balance of payments benefit by having the foreign vehicle companies deposit the proceeds in banks in the United States on a short term basis or acquire short term U.S. securities. In any case, if OFDI does continue to require a Luxembourg or Curaçao company under certain circumstances to deposit the proceeds of long-term foreign borrowing in the United States, it is unlikely that any great problem would be raised because, as indicated above, a Luxembourg or a Curaçao company would not have to meet the same "80-20" test involving U.S. source income.

(xii) *Convertibility into Stock of Parent Company.* Most Eurobond issues by industrial companies in 1968 and 1969 have provided that the debentures would be convertible into the stock of the parent company.[61] A convertible debenture generally commands a lower rate of interest because it enables the foreign investor to have the advantage of a fixed rate of interest, free from withholding tax, with the market value of his debenture tied to the performance of the parent company stock on security exchanges in the United States.

Thus far, it is generally believed that purchasers of Eurodollar debentures which

[60] Wall Street Journal, April 17, 1969, at 1, col. 6.

[61] Of the 77 convertible issues shown on the list referred to in note 1, *supra*, 63 were issued in 1968 and 1969.

are convertible into stock of the U.S. parent company do not for the most part convert them into the underlying common stock of the parent company.[62] A holder of a Eurodollar debenture has an instrument which is free of withholding tax and is in bearer form. If he converts it, he obtains shares of common stock which are subject to U.S. withholding tax and which are in registered form. In many cases this would not be significant because he would be in a position to take advantage of a treaty exemption from such withholding tax or of an offsetting tax credit against his own income tax for such tax. In other cases, however, this would not be practicable. Accordingly, if he desires to liquidate his investment in the security, it may be much simpler for him to sell it as a bearer instrument to another purchaser. The price of the debenture at the time would, of course, reflect the price of the underlying common stock.

The use of convertible debentures creates the possibility that for U.S. federal income tax purposes a benefit can be derived if the debenture issue is that of a Delaware Finance Subsidiary. The nature of the benefit, however, may vary depending on whether the conversion privilege is exercisable against a Delaware Finance Subsidiary or against the parent company. If the conversion right is against the parent company (that is, the parent company agrees upon the delivery of the debentures to it to deliver its stock in return therefor), a Delaware Finance Subsidiary may be able to claim that its debentures were issued at a discount which can be amortized over the life of the debentures. This is on the theory that the purchaser of a debenture actually acquires two separate rights against two separate parties, even though he has purchased a single instrument. Thus, he has acquired a debt obligation of a Delaware Finance Subsidiary and an undertaking by the parent company permitting him to exchange his debentures for the stock of the parent. On that basis, a portion of the price paid for the debenture would be attributed to the debt obligation and the remainder to the "conversion" right issued by the parent company. The amount of the original issue discount would therefore be the value of the conversion right. This discount, which would be valued by the underwriters at the date of issue, could be amortized for tax purposes over the life of the debentures. If, however, the debentures were converted prior to their maturity, the deduction for the remaining unamortized original issue discount might be lost.

The Delaware Finance Subsidiary might not have sufficient net income against which to apply the amortization deduction. Accordingly, this approach might not

[62] Possible reasons for conversion would seem to include the following: (i) if the yield on the common stock is higher than that on debentures (probably rare in today's market); (ii) an investor with a large block of debentures to sell may have trouble in disposing of it without depressing the price in the relatively thin debenture market, whereas there probably is a much larger market for the parent company stock; and (iii) if there is a long delay in the start of the conversion period, the price of the debentures may get out of adjustment from their proper conversion value with the result that arbitragers will purchase debentures and convert at the start of such period.

be attractive unless the parent company were filing a consolidated return and would thus be able to use the deduction of the Delaware Finance Subsidiary against its own income.

If, in lieu of convertible debentures, there were issued a package consisting of a debenture of the Delaware Finance Subsidiary and a warrant exercisable against the parent company, the original issue discount to the subsidiary in the amount of the value of the warrant would clearly be applicable. This is basically the same deduction that it is expected would be available in the case of convertibility against the parent company. On the other hand, when the proceeds of the issue are to be invested in foreign affiliates, this is not as desirable as the use of convertible debentures. OFDI takes the position that, if a package of debentures and warrants is issued, only the value of the debentures constitutes the proceeds of long-term foreign borrowing that may be used to obtain the deduction against transfers of capital. The sale of the warrants is regarded as a separate security for which they do not permit credit against foreign investments. Note that if the warrant is exercisable against the parent company, it would not be subject to interest equalization tax, but query the result if it were exercisable against the Delaware Finance Subsidiary.

If the convertible debentures are convertible against the Delaware Finance Subsidiary, it is unlikely that there would be any original issue discount deduction since the purchaser would be acquiring rights against a single party represented by a single instrument. On the other hand, it is probable that upon conversion the Delaware Finance Subsidiary will be entitled to a deduction in an amount equal to the excess of the fair market value of the stock of the parent company over the face value of the debentures. In other words, if a $1,000 debenture were converted into stock of the parent company having a market value of $1,300, the Delaware Finance Subsidiary could claim a deduction from ordinary income of $300. This alternative creates the problem, however, that the Delaware Finance Subsidiary may realize capital gain upon the delivery of the stock of the parent company upon conversion. The amount of the gain probably would be the excess of the fair market value of the stock over the tax basis for the stock in the hands of the Delaware Finance Subsidiary. If the parent company issued its stock to such subsidiary, the tax basis would be questionable and conceivably could be zero. Similarly, if the parent company contributed money to the Delaware Finance Subsidiary which was used to purchase the stock from the parent company, this might be equivalent to the parent company issuing its stock directly to such Subsidiary. Probably the prudent course would be to have the Delaware Finance Subsidiary purchase the parent company stock on the open market just before the anticipated conversion. Alternatively, the parent company could purchase the stock itself at that time and contribute it to such subsidiary.[63] In this way the

[63] This could, in theory, be regarded as the redemption of stock and the issuance of new stock to the Delaware Finance Subsidiary with the same question as to basis.

tax basis would be approximately the market value on the date of conversion. If there were any substantial purchases of stock of the parent company by either the parent company or the Delaware Finance Subsidiary in a relatively short interval of time (for instance, precipitated by a call for redemption), there could be limitations on the ability to purchase the stock on the open market because there also would be in existence a continuing offer of such stock under the Securities Act.[64] Moreover, if a large number of debentures were converted within a comparatively short period, the Delaware Finance Subsidiary would have a very large deduction within that taxable year and might show an operating loss to which the parent company could succeed only by liquidation, unless consolidated returns were filed.

Generally speaking, if a Luxembourg or Curaçao company were used as the financing vehicle, it would be difficult to achieve the same tax benefits to the parent company.[65]

Under the Regulations, the delivery of stock of a parent company to holders of debentures in connection with long-term foreign borrowing of the parent company or a Delaware Finance Subsidiary is deemed to be a repayment of the borrowing to the extent of the principal amount of the debentures surrendered by such holders.[66] Such repayment constitutes a transfer of capital, not in the year in which the conversions occurs, but in the year immediately following the year in which conversion occurs.[67] The purpose of this delay is to permit a U.S. company to plan its investments for the year within the scope of its investment allowables. If conversions occurring at the end of the year were charged currently, it would not be able to predict their amount and might thus involuntarily exceed its investment allowables for the year. A somewhat similar problem arises in the certificate filed by the

[64] SEC Exchange Act rule 10b-6, 17 C.F.R. § 240-10b-5 (1968).

[65] It is possible that for U.S. tax purposes a parent company could take the position that a Luxembourg or Curaçao company which issued debentures convertible against the parent company had issued them at an original issue discount. The reason behind this would again be that each debenture really represented two security rights issued by two parties although represented by a single instrument. Thus, there is the debt obligation of the foreign finance vehicle and the conversion privilege of the parent company. The value of the latter would be the original issue discount and would presumably (for U.S. tax purposes) be amortizable over the life of the issue. The benefit of such a discount would be obtainable through the increased effect of the tax credit. Thus, suppose the foreign finance vehicle has $100 of income on which it pays $45 of foreign tax. When the remaining $55 is paid to the parent company as a dividend, the parent company can take a credit for $45 tax paid against the $100 of income. If, however, the Internal Revenue Service would recognize an amortization of the original issue discount in the amount of $10, the income of the foreign finance vehicle for U.S. tax purposes would be only $90 while the tax credit would remain at $45. Of course, the limitations factor here would be that, by design, the financing vehicle would have relatively little income.

As to tax problems of foreign finance vehicles, see Kingson, *Investment in Western Europe Under the Foreign Direct Investment Regulations: Repatriation, Taxes and Borrowings*, 69 COLUM. L. REV. 1 (1969).

[66] OFDI Reg. § 324(b)(2). This is so even though the stock may have a considerably higher value at the time of conversion. Note that there is no equivalent provision in the Regulations dealing with the borrowing by a foreign affiliate which is convertible into stock of the parent company. It is submitted, however, that under OFDI § 312 the result should be the same.

[67] OFDI Reg. § 1002(a)(3).

company at the time of the initial issuance of the debentures. That certificate refers to the expectation of the company as to the repayment of the debentures. In the ordinary course of events, the company cannot know when conversion will occur, and, accordingly, the Regulations provide that in giving the certificate the company may disregard potential transfers of capital resulting from conversions, provided that the potential conversions cannot be disregarded if either (1) the debentures have an original maturity of less than seven years, or (2) the debentures are not sold in a public offering and are convertible within three years from the date of issuance.[68] Accordingly, if convertible debentures are delivered in a private transaction (for example, as consideration for the acquisition of a business abroad), they should provide that they are not convertible for three years.

It should further be noted that once the debentures become convertible there is a continuous offer of the stock of the parent company, and it is necessary to have outstanding a registration statement with respect to such stock (on Form S-1 or Form S-7) under the Securities Act.

(xiii) *Underwriting.* The terms of the Eurobonds are normally negotiated with the underwriters. In most cases Eurobond issues do not provide for covenants against additional debt or restrictions on dividends or any tests relating to debt or assets. The guarantee of the parent company in many convertible issues has been subordinated to other debt of that company.

As otherwise indicated in this article, it is important that the underwriters agree not to sell the debentures in the United States or to residents or nationals of the United States and to obtain similar agreements from the selling dealers. It is also important that, if the proceeds are to be used for the purposes of investment in foreign affiliates, the underwriters make a comparable undertaking with respect to sales to Canadian persons.[69]

(xiv) *Trustee.* Most Eurobond issues of U.S. companies provide for a trustee acting under an indenture. This seems particularly desirable in the case of convertible debentures. There is, however, no legal requirement for a trustee and where no conversion feature is involved, many issues provide simply for a fiscal agent. If a fiscal agent is utilized, the documentation is somewhat simpler because a relatively simple fiscal agency agreement, rather than an indenture, is used. The principal duty of the fiscal agent is the payment of the principal, premium, and interest either directly or through the paying agents. The fiscal agent does not have any responsibility of enforcing rights of the debenture holders against the issuer.

It is submitted that, if the debentures are expressed in dollars, it is somewhat preferable that the trustee or fiscal agent should be a bank or trust company in the United States rather than a foreign institution. The place of payment of such

[68] OFDI Reg. § 1002(c)(2).

[69] OFDI has suggested language acceptable to it for inclusion in underwriting agreements with respect to the restriction of sales to Canadian persons. GEN. BULL. No. 2, § 1106(c).

dollars is in the United States, and, if a foreign institution is used as the trustee or fiscal agent, it would seem desirable that it should be required to have a principal depositary in the United States to which funds would be paid. It is not beyond the realm of possibility (although admittedly unlikely) that funds made available to the foreign fiscal agent for payment of debt service could become restricted by a change in the regulations governing foreign exchange of the place of incorporation of the fiscal agent. On the other hand, if the fiscal agent is established in the United States, a payment to it of dollars would be payable to the same extent as dollars paid by the issuing company, without the theoretical risk of a change in law of some intervening country.

IV

PROSPECTS FOR THE FUTURE

The first half of 1969 has found the Eurobond market with difficulties similar to those of other money markets of the world: high interest rates and shortages of available funds. This in turn has affected the desire—and ability—of many U.S. companies to resort to such markets.

While the causes of the lack of availability of funds in the Eurobond market are beyond the scope of this article, a foremost cause was the substantial borrowing or drawing on such market by U.S. banks through their foreign branches.[70] This was primarily to relieve the shortage of available funds of such banks in the United States and because such drawings are not subject to the Federal Reserve deposit requirements. In any case, there has developed a tightening of the market by monetary authorities in many countries. Great Britain has long had its foreign controls. France imposed such controls during its recent monetary crises, and Italy, Germany, and Belgium have also imposed restrictions on the lending of such funds.[71]

Nevertheless the Eurobond market continues to exist and at the end of the summer of 1969 has commenced to exhibit renewed vigor. Its long-term outlook is, in the opinion of the author, a foregone conclusion. Over the past several years that market has developed into a strong, viable, and reasonably efficient market where substantial sums of money can be raised. Wholly aside from the "temporary" Foreign Direct Investment Program which has impelled or compelled many U.S. companies to borrow overseas, an offshore source of funds will undoubtedly continue to be attractive to U.S. companies, particularly for the financing of their foreign operations.

Nevertheless, in the short range and while the Regulations continue to be in force, there should be continued expansion of the means available to U.S. companies

[70] *See* Wall Street Journal, April 17, 1969, at 1, col. 6.
[71] *See* Wall Street Journal, April 11, 1969, at 16, col. 3.

of raising funds abroad for use in their foreign affiliates. Under the Regulations, equity sold to foreign nationals does not provide funds available for investment. As a policy matter, sales of equity should (subject to appropriate safeguards against immediate flow-back to this country) count to the same extent as sales of long-term foreign borrowing. Both, from the U.S. balance of payments point of view, are equally beneficial. On the other hand, if equity is sold to foreign residents, it is difficult to ensure that resales will not ultimately end up in the U.S. marketplace so that there will be a resultant outflow of dollars. While many means, involving marking of stock certificates and other similar devices, have been suggested to permit the tracing of shares sold abroad, enforcement in the case of a large class of publicly-traded stock is bound to be uncertain. The wide usage of street names and nominees can well disguise the fact that the beneficial ownership of the shares has been acquired by a U.S. national.

OFDI has recognized the need to permit foreign equity financing by United States companies and in a recent release[72] announced that it would consider applications for Specific Authorizations for relief in that connection with respect to three general types of equity financing. The first of such types of equity financing is the issuance for foreign direct investment purposes of preferred shares by a Delaware Finance Subsidiary which are convertible into or exchangeable for common stock of its parent company. As stated above, Investment Company Act rule 6c-1 permits a Delaware Finance Subsidiary to have nonvoting preferred stock provided that dividends and certain other features thereof are guaranteed by the parent company. The preferred stock, being that of a company "formed or availed of," would be subject to interest equalization tax if acquired by a U.S. resident or national. Moreover, since the Delaware Finance Subsidiary would comply with the "80-20" test, dividends on the preferred stock would not be subject to U.S. withholding tax when paid to a foreign national. A disadvantage from the point of view of a U.S. company to the use of such preferred stock would, of course, be that dividends on such stock would not be deductible for U.S. federal income tax purposes, whereas interest on convertible debentures would be deductible. Nevertheless there are occasions when companies might find it convenient to use the preferred stock route. This may be perhaps because its ability to issue further indebtedness is restricted by covenants in an indenture or merely because its outstanding debt is too high. Furthermore, it could also be useful in providing the equity capital, or at least a substantial portion thereof, required for the Delaware Finance Subsidiary.[73] The parent company could put in a minimum amount of capital for the common stock of the Delaware Finance Subsidiary and have the rest of the equity

[72] Commerce Department Release (FDI69-9), dated July 14, 1969.

[73] So far as is known, the Internal Revenue Service has not ruled on whether it would regard nonvoting preferred stock as debt rather than equity in computing the usual five-to-one debt-equity ratio.

capital raised by such Subsidiary in the form of nonvoting preferred stock sold to foreign nationals. As to the salability of such preferred stock, there would be a guarantee by the parent company, and, if the preferred stock were convertible into the common stock of the parent company, its value should reflect that of the latter. Moreover, as a practical matter, aside from the name and the deductibility of dividends for tax purposes, there is really little to choose between debentures and nonvoting preferred stock.

Once the door has been opened by OFDI, it is submitted that few restrictions should be placed on the form of the preferred stock, other than those absolutely required or desirable to prevent a flow-back of the instrument to the United States. If such an instrument were created, it is not unlikely that it would gradually develop into a "mirror" of the common stock of the parent company in certain transactions. Thus, the preferred stock might bear a rate of dividend which would correspond by some appropriate formula to the dividend paid on the common stock of the parent company. Since this dividend would be guaranteed by the parent company and since the preferred stock would be exchangeable for common stock of the parent company on some ratio, the value of the preferred stock should reflect that of the parent company stock.

The second type of equity financing referred to by OFDI is the exchange by a direct investor of a limited amount of its equity securities in a direct investment transaction with a limited group of foreign nationals. This type of transaction will probably be limited to acquisitions. OFDI states that it will not impose a current charge against the investment allowables of a direct investor if there is adequate assurance that such equity securities will not be sold or otherwise disposed of within three years. Thus, there will have to be some form of a "lock-up" of the shares involved which will permit adequate policing of any disposition thereof. It is not clear what will happen after the three year period, but presumably there may be a charge against investment allowables at that time.

The third type of equity financing would permit a six-year amortization of the resulting charge againt a direct investor's investment allowables where a lock-up would not be suitable. Under this form of relief, in the year in which the equity is issued there would be a charge of only thirty per cent of the total value of the equity used in the direct investment transaction. For each of five succeeding years, a charge equal to ten per cent of the total value would be made and the remaining twenty per cent would not be charged. Apparently, the theory involved in this amortization is that with a spread of holdings of the equity securities, there would be a flow-back of such securities to the United States, but that it would not all occur in one year. From the wording of the release, it is not clear that this formula could be applied to a general public sale by a U.S. company of its shares abroad with an intent to use the proceeds of such sale as required in investments abroad. It seems

more likely that this formula is intended to cover only the situation of an acquisition where there is a fairly large number of holders of stock of the company to be acquired and where a "lock-up" would be unwieldy.

As a long-range proposition, it would seem desirable for Congress to re-examine the whole basis of withholding tax on portfolio securities issued by U.S. companies and held by foreign nationals.[74] From the point of view of the U.S. balance of payments position, it is desirable to have foreign nationals acquire U.S. securities and, what is more, continue to hold them. As indicated above, there are many investors abroad who are not in the position to take advantage of a tax treaty or a tax credit in their own countries. Elimination, or limitation in appropriate cases, of withholding tax may well improve the marketability and the desirability to foreign nationals of securities of U.S. companies. Moreover, as pointed out above, the existence of the interest equalization tax with its subsequent deterrent effect on the acquisition of securities by U.S. nationals, has been one of the legs on which the whole structure of Eurodollar financing has been erected by legal practitioners. As that tax reduces and perhaps disappears, it may be necessary to find some substitute deterrent to ensure that securities of U.S. companies sold or utilized abroad for foreign investment purposes will not readily flow back to the American market.

[74] A recent report of the Committee on Foreign Investments of the Section on International and Comparative Law of the American Bar Association (July 1969) has suggested the possibility that the Internal Revenue Code could be amended to permit the issuance by U.S. companies of a portion of their stock in the form of off-shore equity securities which stock would be appropriately designated or represented by bearer deposit receipts and would, in the hands of a foreign national, be free from U.S. withholding tax on dividends but would be subject to an excise tax, similar to the present interest equalization tax, if acquired by U.S. nationals. It is intended that the proceeds of such off-shore equity securities would be available for investment under the Regulations either upon a public sale of such securities to foreign nationals or in connection with an acquisition of a business from foreign nationals.