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Separate Identity, Tax Treaty Interpretation, and Unilateral Treaty Override: An Analysis of Revenue Rulings 84-152 and 84-153

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SEPARATE IDENTITY, TAX TREATY INTERPRETATION, AND UNILATERAL TREATY OVERRIDE: AN ANALYSIS OF REVENUE RULINGS 84-152 AND 84-153*

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I. INTRODUCTION

Revenue Rulings 84-152[1] and *84-153*[2] held that tax exemptions under the United States-Netherlands Income Tax Convention, as extended to the Netherlands Antilles (the "Antilles"), did not apply to

* The author acknowledges the invaluable assistance of Professor Russell K. Osgood, of the Cornell Law School, in the preparation of this Note.

1. Rev. Rul. 84-152, 1984-2 C.B. 381.
2. Rev. Rul. 84-153, 1984-2 C.B. 383.

interest payments received by two Antilles subsidiaries from U.S. corporations. Beyond imposing a 30 percent withholding tax on the interest U.S. corporations paid to Antilles subsidiaries—the Rulings raise three important legal issues:[3] (1) when should a foreign finance subsidiary be disregarded for tax purposes; (2) how should general treaty language be interpreted; and (3) what effect should a change in revenue laws have on existing tax treaties.[4] These issues arise not only in transactions financed through the Antilles, but also when the separate identity of a foreign subsidiary is challenged and when interpreting tax treaties.[5]

This Note evaluates *Revenue Rulings 84-152* and *84-153* in three parts. Part II provides background that explains the activities leading to the issuance of *Revenue Rulings 84-152* and *84-153*. Part III describes the facts of the Revenue Rulings. Part IV analyzes the major issues raised by the two Rulings. Subsection A of Part IV discusses

3. International tax specialists criticized these Rulings for disregarding judicial precedent and established rules of treaty interpretation, and for violating international law by unilaterally deciding a fundamental treaty issue. *See, e.g.*, Cole & Musher, *Rev. Ruls. 84-152, 84-153 and GCM 37940 Depart from U.S. Treaty Obligations*, 14 TAX MGMT. INT'L J. 265 (1985); Fogarasi & Renfroe, *Is the Benefit of the U.S.-Netherlands Antilles Treaty Terminated for Financing Companies?*, 13 TAX MGMT. INT'L J. 442 (1984); James, *Aiken Industries Revisited*, 64 TAXES 131 (1986).

4. The Tax Reform Act of 1986 adds a branch profits tax to the Code. Although this provision has no direct relevance to this discussion, the Conference Committee indicated that it approved of the results reached in Revenue Rulings 84-152 and 84-153. Specifically, the Joint Committee Report provides:

> The conferees are concerned that the branch-level interest provision may lead to increased use of back-to-back loans by non-treaty residents and improper characterization of interbranch funds by both treaty and nontreaty residents to avoid U.S. tax. The conferees wish to emphasize that back-to-back loans, *as generally provided under present law*, will be collapsed by the I.R.S., and the ultimate recipient, if not treaty protected, will be subject to U.S. tax (emphasis added).

CONF. COMM. REP., H.R. CONF. REP. No. 841, 99th Cong., 2d Sess., *reprinted in* [1986] 41 Stand. Fed. Tax Rep. (CCH) at II-60 (Sept. 21, 1986).

5. The Netherlands Antilles (the "Antilles") has long been a leading tax haven. *See* Frank, *New Hub for an Old Web*, FORBES, Apr. 7, 1986, at 11; Gelinas, *Tax Considerations for U.S. Corporations Using Finance Subsidiaries to Borrow Funds Abroad*, 7 J. CORP. TAX'N 230, 239 (1978); Lederman, *The Offshore Finance Subsidiary: An Analysis of the Current Benefits and Problems*, 51 J. CORP. TAX'N 86 (1979). These six small islands in the Caribbean became a popular location for the formation of foreign finance subsidiaries for several reasons. First, Antilles and the United States have a bilateral tax treaty that exempts from U.S. withholding tax interest income received by an Antilles corporation from a U.S. entity. *See infra* note 24 and accompanying text. Second, the Antilles does not impose withholding taxes on interest paid by Antilles corporations to foreign bondholders. Lederman, *supra*, at 86. Third, the Antilles has a relatively low income tax rate of 24 to 30 percent. Netherlands Antilles Profit Tax Ordinance, art. 15. Fourth, article XII of the United States-Netherlands Antilles Treaty exempts from U.S. taxation interest by an Antilles corporation. *See* United States-Netherlands Income Tax Treaty *infra* note 24, art. XII. Consequently, the availability of United States Foreign Tax Credit for income taxes paid by the Antilles subsidiary made the Antilles income tax effectively cost free to the U.S. parent. (For a detailed discussion of the tax benefits of Netherlands Antilles finance subsidiaries, see generally Lederman, *supra*.) Finally, the Antilles is well known for its stable political and economic environment and its secrecy. *See infra* notes 105-10 and accompanying text.

the separate identity doctrine as it relates to these Rulings; subsection B considers the general canons of treaty interpretation; subsection C addresses the effects of an underlying change in revenue laws on bilateral tax treaties. The Note concludes that *Revenue Ruling 84-152* was correctly decided, but that *Revenue Ruling 84-153* was incorrectly decided.

II. BACKGROUND

The U.S. Internal Revenue Code (the "Code") imposes a 30 percent tax on interest received by a foreign corporation from sources within the United States.[6] The Code imposes the tax to the extent such interest is not effectively connected with the conduct of a trade or business within U.S. territory.[7] The payor of the income deducts and withholds the tax at the source.[8] Arguably, this withholding tax

6. I.R.C. §§ 871(a)(1), 881(a)(1) (CCH 1986).

7. The Deficit Reduction Act of 1984, Pub. L. No. 98-369, 127 Stat. 494 (1984), added §§ 871(h) and 881(c) to the Code, thereby repealing the 30 percent withholding tax on portfolio interest. *See* Granwell, *Repeal of 30 Percent Withholding Tax on Interest Paid to Foreigners*, 13 TAX MGMT. INT'L J. 306 (1984). A major motivation for the repeal was to enable the United States government, with its enormous budget deficit, to reduce the rate of interest it pays on bonds held by foreigners.

The formation of foreign finance subsidiaries was an inefficient method for United States corporations to take advantage of the securities offered on the foreign bond or Eurobond market. Furthermore, such devices led to problems of third country abuse of tax treaties. The repeal provisions affirmed the validity of using foreign finance subsidiaries to avoid withholding tax, but only for obligations issued before June 22, 1984. *See* JOINT COMM. ON TAXATION 98TH CONG., 2d SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 397-98 (Comm. Print 1985).

The repeal applies to registered debt and bearer debt. I.R.C. §§ 871(h)(2), 881(c)(2) (CCH 1986). Registered debt was exempted provided the issuer received a statement that the securities' beneficial owner is not a United States citizen. *Id.* §§ 871(h)(2)(B)(ii), 881(c)(2)(B)(ii). Bearer debt was exempted from withholding tax if it is issued in compliance with the requirements of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), as provided in I.R.C. § 163(f)(2)(B). *Id.* §§ 871(h)(2)(A), 881(c)(2)(A). These restrictions were meant to prevent U.S. taxpayers from escaping tax on debt instruments.

For interest to qualify for the repeal provisions, it had to be "portfolio interest." *Id.* §§ 871(h)(1), 881(c)(1). Portfolio interest included interest on an obligation that is not in registered form. *Id.* § 871(h)(2)(A)(i). It must also meet the reporting requirements set out in I.R.C. § 163(f)(2)(B) to ensure that U.S. taxpayers are not the payees on the foreign obligations. *Id.* § 871(h)(2)(A)(ii). I.R.C. § 163(f)(2)(B) provides that interest on an obligation not in registered form must be payable only outside the United States and its possessions. *Id.* § 163(f)(2)(B)(ii)(I). Such obligation must include on its face a statement that any U.S. person who holds such obligation will be subject to the limitation under the U.S. income tax laws. *Id.* § 163(f)(2)(B)(ii)(II). These reporting provisions ensured that U.S. taxpayers do not claim foreign nationality to evade U.S. taxes.

Under the Act, not all interest was exempt. Non-exempt interest included the following situations. Interest that a bank received on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of trade or business. *Id.* § 881(c)(3)(A). Interest received by a controlled foreign corporation from a related person. *Id.* § 881(c)(3)(C). Interest received by a person who has or is considered to have a 10 percent interest in the U.S. issuer under § 871(h)(3). *Id.* §§ 871(h)(3), 881(c)(3)(B).

8. *Id.* §§ 1441, 1442.

impairs the ability of U.S. corporations to compete in foreign capital markets because of the resulting decrease in investor returns.

Although several statutory exceptions to the withholding tax requirement existed,[9] it was not until passage of the Tax Reform Act of 1984 that generally U.S. corporations were not required to withhold 30 percent tax on interest paid to non-resident alien individuals and foreign corporations.[10] Prior to the 1984 reform, U.S. corporations had created foreign subsidiaries in countries with which the United States had tax treaties exempting, or significantly reducing, foreign-earned interest from the 30 percent withholding tax.[11] This device enabled U.S. corporations to avoid the withholding tax and to take advantage of favorable conditions in the foreign bond market.[12]

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9. Before the Tax Reform Act of 1984, exceptions to the withholding tax requirements included: 1) interest from deposits with persons carrying on the banking business, I.R.C. §§ 861(a)(1)(A), (c) (1984); 2) interest received from a resident alien individual or U.S. corporation earning less than 20 percent of its gross income from sources in the United States, *id.* § 861(a)(1)(B) and 3) interest received from a foreign corporation when it less than 50 percent of the corporation's gross income from all sources in the prior three taxable years was effectively connected with a U.S. trade or business, *id.* § 861(a)(1)(C) and 4) income derived from a foreign central bank of issue from bank's acceptances, *id.* § 861 (a)(i)(E).

10. *Id.* §§ 871(h), 881(c). Since the effective date of July 18, 1984 for repealing the 30 percent withholding tax on portfolio interest, U.S. corporations have been able to structure directly debt financing transactions in foreign markets. For a discussion of the repeal, see *supra* note 6.

11. The use of a foreign finance subsidiary provided the means of avoiding United States withholding tax on interest paid to foreign investors. In the absence of a treaty, interest paid by any U.S. company to the foreign finance subsidiary would be from U.S. sources and thus subject to the 30 percent withholding tax. I.R.C. §§ 871(a), 881(a) (1984). Tax treaties generally reduce or eliminate the 30 percent withholding requirement. *See, e.g.*, Convention for the Avoidance of Double Taxation, Dec. 31, 1975, United States-United Kingdom, art. 11, 31 U.S.T. 5668, 5680, T.I.A.S. No. 9682, *amended by* Additional Protocol, Aug. 26, 1976, 31 U.S.T. 5668, T.I.A.S. No. 9682, *amended by* Additional Protocol, March 15, 1979, 31 U.S.T. 5668, T.I.A.S. No. 9682; *see also* Osgood, *infra* note 136, at 259. Such devices were initially developed in the 1960's in response to the U.S. balance of payments program, which imposed various controls on capital outflows. This program induced U.S. corporations to finance their foreign investments through overseas borrowing because such companies were unable to raise capital on domestic markets for foreign investors.

The balance of payments program consisted of two elements: the 1963 Interest Equalization Tax (the "IET"), and the 1968 Foreign Direct Investment Program. The IET taxed the acquisition of foreign securities by U.S. citizens. Taxable acquisitions include stock and long-term debt obligations of foreign obligors. The 1968 Foreign Direct Investment Program restricted direct investment by U.S. persons of domestic funds in foreign countries. For a discussion of the U.S. balance of payments program, see Boffa, *International Finance Subsidiaries*, Tax Mgmt. (BNA) 2d ser., § 215, at A29-43 (1972). From 1971 to 1974, direct borrowing abroad by U.S. corporations was permitted because the Code had been amended to provide that interest on certain U.S. corporate obligations would be treated as foreign source income and, thus, be exempt from U.S. withholding tax. The Interest Equalization Tax expired in June 1974. Gelinas, *supra* note 5, at 235-36.

12. The foreign bond market or Eurobond market offered long-term debt securities that have a shorter term than securities offered on U.S. markets. During the 1960's the typical maturity for these securities was ten years as compared to twenty-five to thirty years for U.S. securities. *The Use of Offshore Tax Havens for the Purpose of Evading Income*

Initially, the U.S. government accepted these transactions because they enabled domestic entities to gain access to debt instruments on favorable terms.[13] Over time, the use of foreign finance subsidiaries in "tax haven" jurisdictions became increasingly attractive to U.S. investors.[14] The United States recognized that these financing arrangements were of substantial economic and financial importance to the country, influencing both the pattern and volume of foreign investment.[15]

In recent years, however, the U.S. government has been reluctant to condone foreign finance subsidiary transactions in tax haven jurisdictions. These arrangements came into disfavor because persons from countries, not a party to a tax treaty with the United States, took advantage of the treaties' benefits. Moreover, U.S. taxpayers, masquerading as foreigners, attempted to employ these devices to evade U.S. taxation.[16] Consequently, the Treasury Department endeavored to renegotiate several treaties to decrease the attractiveness of interest withholding tax havens.[17] In addition, the Internal Revenue Service (the "Service") issued certain revenue rulings in an attempt to curb the use of foreign finance subsidiaries in tax haven jurisdictions.[18] This process culminated with the issuance of *Revenue Ruling 84-152* and *Revenue Ruling 84-153.*

III. *REVENUE RULINGS 84-152* AND *84-153*

Revenue Ruling 84-152[19] involved a Swiss parent company that

Taxes: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 96th Cong., 1st Sess. 269, 294 (1979) (statement of H. David Rosenbloom, International Tax Counsel, Department of Treasury) [hereinafter *Rosenbloom House Hearings*]. In addition, the foreign bond market offers other advantages, including earlier redemption than comparable U.S. securities and debt covenants that are more flexible than those for comparable obligations available on the U.S. market. Also, public offerings are much faster on the Eurobond market than on the U.S. market, and the foreign bond market may provide a source of foreign currency for United States corporations. *See* Gelinas, *supra* note 5, at 231 n.3.

13. *See Rosenbloom House Hearings, supra* note 1-2, at 281-94.

14. The Antilles and the British Virgin Islands became two popular tax havens because of especially favorable local tax features. *See* sources cited *supra* note 5; *see also* Vogel, Bernstein & Nitsche, *Inward Investments in Securities and Direct Operations Through the British Virgin Islands: How Serious a Rival to the Netherlands Antilles Paradise*, 34 TAX L. REV. 321 (1978).

15. *Rosenbloom House Hearings, supra* note 12, at 281.

16. *See id.* at 278; Diamond & Diamond, *Netherlands Antilles*, in 3 TAX HAVENS OF THE WORLD 1, 10 (1986).

17. Chapeton, *Chapeton Outlines Treasury Policy on Treaty Shopping*, 19 TAX NOTES (Tax Analyst) No. 3, at 250 (April 18, 1986).

18. In addition to the subject Revenue Rulings, see Rev. Rul. 79-65, 1979-1 C.B. 458 (concluding that a domestic corporation must provide adequate information to establish that its relationship with the Antilles' parent was not formed solely for the purpose of tax avoidance).

19. Rev. Rul. 84-152, 1984-2 C.B. 381.

maintained two wholly-owned subsidiaries: one in the United States and the other in the Antilles.[20] The U.S. subsidiary needed funds to improve its production capabilities. On August 1, 1984, the Swiss parent lent funds to the Antilles subsidiary.[21] Thereafter, the Antilles subsidiary re-lent the funds to the U.S. corporation.[22] The U.S. subsidiary paid interest to the Antilles corporation at an 11 percent rate; the Antilles corporation paid interest to the Swiss parent at a rate of 10 percent.[23] The Antilles subsidiary thus earned a profit on the 1 percent spread.

The parties claimed that the U.S. subsidiary's interest payments were entitled to exemption from withholding taxes under article VIII(1) of the United States-Netherlands Income Tax Convention as extended to the Antilles (the "United States-Antilles Treaty").[24] The Treaty provided:

> Interest (on bonds, securities, notes, debentures or on any form of indebtedness) . . . *derived* from sources within the United States *by* a resident or corporation of the Netherlands . . . not engaged in trade or business in the United States through a permanent establishment, shall be exempt from United States tax . . . .[25]

Revenue Ruling 84-152 held that the interest paid by the U.S. corporation to the Antilles corporation did not qualify for the withholding tax exemption under article VIII(1) of the United States-Antilles Treaty[26] because the Antilles corporation did not have "complete dominion and control" over the interest payment—a requirement implied by the words "derived . . . by" in article VIII(1) of the Treaty.[27] Rather, the Antilles subsidiary was "merely a conduit for the passage of [the U.S.

20. *Id.* at 382.
21. *Id.*
22. *Id.*
23. *Id.*
24. Convention with respect to Taxes on Income and Certain Other Taxes, Apr. 29, 1948, United States-Netherlands, 62 Stat. 1757, T.I.A.S. No. 1855, *supplemented by* Protocol Facilitating Extension of the Convention to the Netherlands Antilles, June 15, 1955, 6 U.S.T. 3696, T.I.A.S. No. 3366, *modified by* Agreement Relating to the Convention and Protocol, June 24-Nov. 10, 1955, 6 U.S.T. 3703, T.I.A.S. No. 3367, *modified and supplemented by* Protocol Relating to the Extension to the Netherlands Antilles, Oct. 23, 1963, 15 U.S.T. 1900, T.I.A.S. No. 5665, *modified and supplemented by* Convention Relating to the United States-Netherlands Convention, Dec. 30, 1965, 17 U.S.T. 896, T.I.A.S. No. 6051 [hereinafter United States-Netherlands Income Tax Treaty]. A new income tax treaty between the United States and the Antilles was signed on August 8, 1986. Article 11 of the new treaty reduces the interest withholding tax benefits that existed under the former treaty. Convention for the Avoidance of Double Taxation, August 8, 1986, United States-Netherlands Antilles, art. 11, — U.S.T. —, T.I.A.S. No. —, *reprinted in* 2 Tax Treaties (CCH) at ¶ 589714. As of this writing, however, the new treaty has not yet entered into force.
25. United States-Netherlands Income Tax Treaty, *supra* note 24, art. VIII(1) (emphasis added).
26. Rev. Rul. 84-152, 1984-2 C.B. 381, 382.
27. 1984-2 C.B. at 382. *See* United States-Netherlands Income Tax Treaty, *supra* note 24, art. VIII(1).

subsidiary's] interest payments to [the Swiss parent]."[28] The Ruling stated that the primary purpose for the Antilles subsidiary's involvement in the transaction was "to attempt to obtain the benefits of Article VIII(1) interest exemption . . . thus, resulting in the avoidance of United States tax."[29] Consequently, the Antilles subsidiary lacked "sufficient business or economic purpose to overcome the conduit nature of the transaction, even though it [could] be demonstrated that the transaction serve[d] some business or economic purpose."[30]

Revenue Ruling 84-153[31] involved a slightly different factual situation from that in *Revenue Ruling 84-152* because the Antilles subsidiary made public bond offerings. In *Revenue Ruling 84-153*, a U.S. parent corporation maintained United States and Antilles subsidiaries.[32] The U.S. subsidiary needed funds to increase its working capital so it could improve its production facilities.[33] The parent corporation wanted to obtain the funds outside the United States because of lower interest rates.[34] The Antilles subsidiary, therefore, issued bearer bonds to foreign persons in two public offerings, on July 1, 1984, and on September 1, 1984.[35] The Antilles corporation lent the proceeds of the offering to the U.S. subsidiary at an interest rate that was one percentage point higher than the rate payable to the foreign bond holders, thus retaining the spread.[36]

As in *Revenue Ruling 84-152, Revenue Ruling 84-153* held that the interest paid by the U.S. subsidiary to the Antilles corporation did not qualify for the withholding tax exemption under article VIII(1) of the United States-Antilles Treaty because the Antilles corporation did not "deriv[e] the interest," but was merely "a conduit for the passage of [the U.S. subsidiary's] interest payments to the foreign bondholders."[37] The Ruling stated that the primary purpose for involving the Antilles subsidiary in the transaction was to obtain the exemption provided by article VIII(1) and thereby avoid U.S. taxation.[38]

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28. Rev. Rul. 84-152, 1984-2 C.B. 381, 382.
29. *Id.*
30. *Id.* The Service concluded that the interest payments were subject to a 5 percent U.S. withholding tax under article VII(1) of the United States-Switzerland Income Tax Treaty. *Id.*
31. Rev. Rul. 84-153, 1984-2 C.B. 383.
32. *Id.* at 383.
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.* The result of Revenue Ruling 84-153 was the same with respect to the bond issuances on both July 1, 1984, and September 1, 1984; nonetheless, because the Code had been amended during the ensuing period, the Service treated these two issuances differently. As part of the Tax Reform Act of 1984 (the "1984 Act"), Congress repealed the 30 percent withholding tax on portfolio interest paid by U.S. corporations to foreign investors

IV. ANALYSIS

A. The Separate Tax Identity Doctrine

1. Legal Attacks on Foreign Finance Subsidiaries

Because *Revenue Rulings 84-152* and *84-153* effectively disregard the corporate separateness of the Antilles subsidiary, the Rulings raise the question of when is it appropriate to disregard the separate identity of a foreign finance subsidiary. The U.S. government has adopted several arguments to address the problem of separate identity of foreign finance subsidiaries in light of perceived abuses of tax treaties. The government's primary concern was that foreign nationals were receiving tax benefits under a treaty to which their home countries were not a party.[39] In addition, the government feared that U.S taxpayers were inaccurately claiming foreign nationality to evade U.S. taxation.[40] The government hoped to curtail perceived abuses by disregarding the separate identity of foreign finance subsidiaries.

The government first argued that the foreign finance subsidiary

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on bonds issued after July 18, 1984. I.R.C. §§ 871(h), 881(c) (CCH 1986). For a discussion of the repeal, see *supra* note 6. The repeal provisions provided for a "safe harbor" date of June 22, 1984; thus, obligations issued before June 22, 1984, were entitled to the article VIII exemption. Since the July 1, 1984, issuance occurred before the July 18, 1984, effective date of repeal of withholding tax and after June 22, 1984, the Service held that interest on such obligations did not qualify for the repeal of withholding tax on "portfolio interest." Rev. Rul. 84-153, 1984-2 C.B. 383, 384. This determination meant that bonds issued between June 22, 1984, and July 18, 1984, were not protected by the safe harbor of the 1984 Act, whereas bonds issued before June 22, 1984, were protected.

To rectify this situation, the Treasury Department, by news release shortly after the publication of Revenue Ruling 84-153, invited taxpayers who made offerings through the Antilles between June 18 and July 22, 1984, to seek relief. I.R.S. News Release IR-84-110 (Oct. 18, 1984); Announcement 84-105 Based on I.R.S. News Release IR-84-110 (Oct. 18, 1984), 1984-46 I.R.B. 57. The Service granted relief in several instances. Priv. Ltr. Ruls. 85-28-031 (April 16, 1985), 85-25-031 (March 22, 1985), 85-20-095 (Feb. 20, 1985), 85-20-094 (Feb. 20, 1985), 85-20-093 (Feb. 20, 1985), 85-20-092 (Feb. 20, 1985), 85-20-062 (Feb. 20, 1985), 85-20-061 (Feb. 19, 1985), 85-20-055 (Feb. 19, 1985).

Subsequently, in Rev. Rul. 85-163, 1985-2 C.B. 349, the Service modified the holding of Revenue Ruling 84-153 (Revenue Ruling 85-163 similarly modified the holding of Revenue Ruling 84-152) *Id.* Revenue Ruling 85-163 stated that Revenue Ruling 84-153 would not apply to interest payments made in connection with debt obligations issued prior to October 15, 1984, the date the Ruling was published in the Internal Revenue Bulletin, or interest payments made in connection with debt obligations issued on or after October 15, 1984, pursuant to a binding written agreement entered into prior to October 15, 1984. *Id.* These actions mooted the Ruling's retroactive effect. The second offering was made on September 1, 1984, after the repeal of the withholding tax on portfolio interest's effective date. The Ruling stated that the September 1, 1984, offering did not meet the reporting requirements for bearer obligations, a prerequisite for the interest payment to be nontaxable under the 1984 Act. Rev. Rul. 84-153, 1984-2 C.B. 383, 383-84; *see also supra* note 6 and accompanying text. As a result, the interest payments were treated as paid directly to foreign investors and subject to thirty percent withholding or the applicable treaty rate of the foreign investors. Rev. Rul. 84-153, 1984-2 C.B. 383, 383-84.

39. *Rosenbloom House Hearings, supra* note 12, at 278.

40. Diamond & Diamond, *supra* note 16, at 10.

was insufficiently or thinly capitalized.[41] Both *Revenue Rulings 84-152* and *84-153* specifically state, however, that the Antilles subsidiaries were not thinly capitalized.[42]

In its second approach, the government argued that the foreign finance subsidiary either conducted a trade or business in the United States or had a "permanent establishment" in the United States.[43] Again, both Rulings state that the Antilles subsidiary was not engaged in a trade or business in the United States and had no "permanent establishment in the United States."[44]

With the government's first and second approaches ruled out, *Revenue Rulings 84-152* and *84-153* applied the broader "conduit," or "sham" theory to disregard the separate identity of the Antilles subsidiaries. This theory relies on the premise that the foreign finance subsidiaries are paper corporations, without employees or independent revenues.[45] Significantly, bonds of the subsidiary generally contain a covenant giving the parent the right to call them if they become sub-

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41. While U.S. capital controls were still in effect, the Service issued a series of rulings stating that as long as the debt-to-equity ratio of the subsidiary did not exceed five-to-one, the Service would recognize the indebtedness as the subsidiary's indebtedness and would treat the subsidiary as a separate corporate entity. *See* Rev. Rul. 69-377, 1969-2 C.B. 231, 233 (no U.S. withholding tax on interest from foreign subsidiary debt obligation paid to foreign corporations if less than 20 percent of the foreign subsidiary's gross income is derived from sources within the United States); *see also* Rev. Rul. 73-110, 1973-1 C.B. 454; Rev. Rul. 69-501, 1969-2 C.B. 233. With the easing of U.S. capital controls in 1974 (the Interest Equalization Tax and the Foreign Direct Investment Regulations lapsed in this year), the Service revoked the above Rulings and stated that it would determine the validity of a finance subsidiary on the facts and circumstances of each case. Rev. Rul. 74-464, 1974-2 C.B. 47. However, the Service, as provided in the Tax Reform Act of 1984, resurrected the five-to-one debt-to-equity ratio requirement of the earlier Rulings in order for obligations issued before June 22, 1984, to be grandfathered in under the repeal provisions. Rev. Rul. 86-6, 1986-4 I.R.B. 4. For a discussion of debt-to-equity ratios in other areas of tax law, see generally Plumb, *Federal Income Tax Significance of Corporate Debt: A Critical Analysis and Proposal,* 26 TAX L. REV. 369, 507-19 (1971) (cases in other areas of tax law indicate that a three-to-one debt-to-equity ratio generally will not be attacked by the Service).

If a corporation forms a foreign finance subsidiary with a low debt-to-equity ratio, the Service may still attack it on grounds of thin capitalization when the subsidiary loans the equity contributed by the parent to lower the subsidiary's debt-to-equity ratio back to the parent's affiliates. If this occurs, the Service may consider the transaction a reduction in the parent's investment in the foreign finance subsidiary. Lederman, *supra* note 5, at 88.

42. Rev. Rul. 84-152, 1984-2 C.B. 381, 382; Rev. Rul. 84-153, 1984-2 C.B. 383, 383.

43. Tax treaties generally provide that an exemption from U.S. taxation is not available if the foreign entity has a permanent establishment in the United States. *See, e.g.*, Convention for the Avoidance of Double Taxation, *supra* note 11, art. 7. If the Service deems the entity to be conducting a trade or business within the United States, the entity's effectively connected income is taxed at graduated rates. I.R.C. §§ 871(b), 882 (1982). *See* Gelinas, *supra* note 5, at 255; Lederman, *supra* note 5, at 89; Williams, *Permanent Establishments in the United States,* 29 TAX LAW. 277 (1976).

44. Rev. Rul. 84-152, 1984-2 C.B. 381, 382; Rev. Rul. 84-153, 1984-2 C.B. at 383.

45. *Rosenbloom House Hearings, supra* note 12, at 295.

ject to withholding taxes.[46] In addition, the U.S. parent typically guarantees the payment of interest and principal.[47]

2. *The Standards for Disregarding Separate Identity*

Although numerous decisions established that the government ordinarily will not disregard a corporation's identity for tax purposes, the "sham" or "conduit" theory sometimes has warranted disregarding the separate identity of a foreign finance subsidiary.[48] The established tax standard for evaluating the separate identity of an entity is lenient.[49] An entity "formed for a substantial business purpose or actually engaged in substantive business activity" will ordinarily have a separate tax identity.[50]

Courts have narrowed the "substantive business activity" test. Although the permissible amount of activity may be minimal, courts will disregard the form of the transaction under limited circumstances,[51] such as "when the taxpayer has conducted business as if he and the corporation were one and the same, thereby ignoring the fact that in tax law he and the corporation are considered to be two separate entities."[52] This exception does not apply to *Revenue Rulings 84-152* and *84-153* because presumably the Antilles subsidiaries in question kept separate books and met the formal requirements for separate corporations.

Two other limitations, discussed later in the analysis, are relevant to this discussion. Tax authorities may disregard a corporate entity when the entity assumes the entire risk of loss on the transaction[53] and

46. Segal & Davis, *Repeal of the 30% Withholding Tax on Portfolio Interest*, 11 INT'L TAX J. 125, 127 (1985).

47. Gelinas, *supra* note 5, at 232.

48. *See, e.g.*, Burnett v. Commonwealth Improvement Co., 287 U.S. 415 (1932) (unusual cases may require disregarding the corporate form); Britt v. United States, 431 F.2d 232, 233 (5th Cir. 1970) (the corporate entity will generally be recognized rather than disregarded for tax purposes) (citing New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934)).

49. *See, e.g.*, Republic Petroleum Corp. v. United States, 397 F. Supp. 900, 912 (E.D. La. 1975), *modified*, 613 F.2d 518 (5th Cir. 1980) (the court recognized separate corporate identity despite lack of corporation telephones, employees, and offices).

50. Bass v. Comm'r, 50 T.C. 595, 600 (1968) (holding a Swiss corporation that signed working agreements, collected royalties, made investments, and carried out other business activities was a separate identity for tax purposes); *see also* National Carbide Corp. v. Comm'r, 366 U.S. 422 (1949); Moline Properties, Inc. v. Comm'r, 319 U.S. 436 (1943); National Investors Corp. v. Hoey, 144 F.2d 466 (2d Cir. 1944); Aldon Homes, Inc. v. Comm'r, 33 T.C. 582 (1959).

51. *See, e.g.*, *Moline Properties*, 319 U.S. at 440 (holding that leasing property and receiving rental income satisfied the substantive business activity standard); *Britt*, 431 F.2d at 235 ("a determination of whether a corporation is to be considered as doing business is not necessarily dependent upon the quantum of business" (citations omitted)).

52. *Britt*, 431 F.2d at 233.

53. *See* Carnation Co. v. Comm'r, 45 T.C. 566 (1966); Rev. Rul. 78-118, 1978-1 C.B. 219, 220; *see also infra* notes 90-97 and accompanying text.

when tax avoidance is the only business purpose for the formation of a corporation and the use of a certain transaction.[54]

3. *Gregory v. Helvering*

Revenue Rulings 84-152 and *84-153* relied on *Gregory v. Helvering*[55] and *Aiken Industries v. Commissioner*[56] in concluding that the Antilles subsidiaries qualified as shams because the requisite business activity and purpose were absent. The facts of these two Revenue Rulings, however, differ substantially from *Gregory* and *Aiken Industries.* In *Gregory,* the petitioner temporarily formed a corporation under the Code's reorganization provisions. The petitioner then transferred valuable shares of stock held by her wholly-owned corporation to this newly-formed corporation and subsequently liquidated the newly-formed corporation. The purpose of the "reorganization" and liquidation of the temporarily-formed entity was to allow the petitioner to sell the shares for her individual profit while reducing the tax burden that would have resulted had the newly formed corporation distributed the shares to her as an ongoing dividend rather than as a liquidating distribution.[57]

Petitioner in this case formed a corporation solely for the purpose of achieving tax advantages and liquidated the corporation shortly after its formation to achieve that purpose. Both formation and utilization of the corporation contravened the purpose of the Code's reorganization provisions. It satisfied neither the minimum activity nor the business purpose test required for treatment as a separate taxable entity. The Supreme Court concluded that the newly formed corporation served no corporate or business purpose other than reducing tax liability and assessed the petitioner with tax.[58]

Revenue Rulings 84-152 and *84-153* are distinguishable from *Gregory* inasmuch as the Antilles subsidiaries in the Revenue Rulings appeared to have some profit-making potential in the relevant transactions. Furthermore, the taxpayers in the Revenue Rulings did not appear to have formed the Antilles subsidiaries specifically to engage

54. *See infra* notes 99-123 and accompanying text; *see also* Gregory v. Helvering, 293 U.S. 465, 469 (1935); National Investors Corp. v. Hoey, 144 F.2d 466, 468 (2d Cir. 1944); Hospital Corp. of America v. Comm'r, 81 T.C. 520 (1983); Ross v. Comm'r, 60 T.C. 569 (1973); Larrabee v. United States, 68-2 U.S.T.C. 9442 (C.D.Cal. 1968); Siegel v. Comm'r, 45 T.C. 566 (1966).

55. 293 U.S. 465 (1935).

56. 56 T.C. 925 (1971), *acq. on other grounds* 1972-2 C.B.1.

57. *Gregory,* 293 U.S. at 467.

58. *Id.* at 469.

in the one transaction the Rulings attack.[59] Also, the Antilles subsidiaries' activities did not contravene the purpose of a revenue statute or treaty.[60] Therefore, citing *Gregory* as controlling precedent in both Rulings is not compelling without a more specific explanation as to how the case resolves the issues presented in the Rulings.

4. Aiken Industries v. Commissioner

Aiken Industries,[61] a more appropriate precedent for *Revenue Rulings 84-152* and *84-153*, involved a foreign subsidiary formed in a tax haven jurisdiction. In *Aiken Industries*, a U.S. corporation borrowed funds from its Bahamian parent.[62] The Bahamian parent assigned the obligation of the U.S. subsidiary to another subsidiary organized in Honduras.[63] The purpose of this exchange was to provide the Bahamian parent with a zero rate of withholding tax on interest paid by the U.S. corporation under the United States-Honduras Income Tax Treaty.[64] In return for receipt of the U.S. corporation's obligation, the Honduran corporation issued its own notes to the Bahamian parent.[65] The Honduran notes had the same principal amounts and interest rates as the U.S. subsidiary's notes.[66] The Honduran corporation made no profit on the transaction because the U.S. corporation paid the interest to the Honduran corporation which, in turn, paid all interest to the Bahamian parent.[67]

Although *Aiken Industries* noted that a tax avoidance motive alone is not sufficient to prevent application of an international tax

59. This is especially true of Revenue Ruling 84-153 because the Antilles subsidiary in that Ruling was established in 1982. Rev. Rul. 84-153, 1984-2 C.B. 383, 383. Revenue Ruling 84-152 does not state when the Antilles subsidiary was formed.

60. The Service may claim that the activities contravened the intent of the Treaty's contracting parties. This Note argues that the Service's claim is incorrect. *See infra* notes 136-49 and accompanying text.

61. Aiken Indus. v. Comm'r, 56 T.C. 925 (1971), *acq. on other grounds* 1972-2 C.B. 1.

62. *Id.* at 926.

63. *Id.*

64. *Id.* at 929. Article IX of the Convention Between the United States of America and the Republic of Honduràs for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income provided:

> Interest on bonds, securities, [or] notes . . . from sources within one of the contracting States received by a . . . corporation . . . of the other contracting State not having a permanent establishment within the former State at any time during the taxable year in which such interest is received, shall be exempt from tax by such former State.

Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, June 25, 1956, art. IX, United States-Honduras, 8 U.S.T. 219, 225, T.I.A.S. No. 3766.

At the time *Aiken Indus.* was decided no treaty existed between the United States and the Bahamas.

65. *Aiken Indus.*, 56 T.C. at 926.

66. *Id.* at 930.

67. *Id.*

treaty,[68] the opinion concluded that the Honduran corporation was "merely a conduit" for the passage of interest payments from the U.S. corporation to the Bahamian parent.[69] To reach this conclusion, the court interpreted the "received by" language in article IX of the Convention to imply "complete dominion and control over the funds."[70] Consequently, the court denied the parent corporation an exemption from withholding tax.[71]

Aiken Industries can be distinguished from *Revenue Rulings 84-152* and *84-153*. The tax avoidance device in *Aiken Industries* involved a pre-existing debt obligation, whereas *Revenue Rulings 84-152* and *84-153* did not. In addition, the Honduran subsidiary in *Aiken Industries* earned no profit on the transaction because the amounts it received and paid out were identical. In *Revenue Rulings 84-152* and *84-153*, the Antilles subsidiaries retained a 1 percent interest differential.

These distinctions, however, may not be sufficient to overcome the similarities between *Revenue Ruling 84-152* and *Aiken Industries*. As in *Aiken Industries*, the ultimate lender and the ultimate borrower in the Revenue Ruling were members of the same controlled group.[72] Also, in *Revenue Ruling 84-152*, the Antilles subsidiary was not sufficiently liquid to make the loan to the U.S. subsidiary without first receiving funds from its parent.[73] This aggravating circumstance may require conduit treatment. The only substantial factual difference between *Revenue Ruling 84-152* and *Aiken Industries* was that rather than earn nothing on the transaction, the Antilles subsidiary in *Revenue Ruling 84-152* kept a 1 percent interest differential.[74] If this 1 percent interest spread did not, along with its other activities, qualify as a substantive business activity and if no substantial business purpose existed, then it appears that the Service properly decided this Ruling.

On the other hand, the distinctions between *Revenue Ruling 84-153* and *Aiken Industries* are mitigating. Accordingly, the conduit treatment of *Aiken Industries* may not be appropriate under the facts of *Revenue Ruling 84-153*. In *Revenue Ruling 84-153*, the bonds were sold in public offerings to foreign persons unrelated to the parent corporation.[75] In addition, the form of the transaction suggests a business purpose. The Antilles subsidiary may have been an independently

68. *Id.* at 933 (citing Gregory v. Helvering, 293 U.S. 465, 469 (1935)).
69. *Id.* at 934.
70. *Id.* at 933.
71. *Id.* at 934-35.
72. Rev. Rul. 84-152, 1984 C.B. 381, 382. For a definition of "controlled group," see I.R.C. § 1563(a) (CCH 1986).
73. Rev. Rul. 84-152, 1984 C.B. 381, 382.
74. *Id.*
75. Rev. Rul. 84-153, 1984-2 C.B. 383, 383.

attractive investment so that the foreign persons bought the bonds without guarantees from the parent corporation.[76] These factors suggest that the Antilles subsidiary had some degree of autonomy, indicating that it should have been treated as a separate entity. Additionally, as in *Revenue Ruling 84-152*, the Antilles subsidiary in *Revenue Ruling 84-153* retained a 1 percent interest differential.[77] This retained spread, along with its other activities, may have qualified as a substantive business activity.

5. *Fixed Interest Differentials: Substantive Business Activity Analysis*

In both *Revenue Ruling 84-152* and *Revenue Ruling 84-153*, the Antilles subsidiary retained a 1 percent interest differential. Some commentators contend that such a differential constitutes a substantive business activity because it implies a profit-making motive.[78]

An earlier ruling, *Revenue Ruling* 76-192,[79] sheds light on the analysis of fixed-interest spreads although the Ruling involved a different issue.[80] In this Ruling, a wholly-owned foreign subsidiary sold debt obligations to underwriters for offer and sale to the public.[81] The subsidiary deposited the proceeds from the sale with an unrelated foreign financial institution.[82] The foreign financial institution lent the funds at a 1 percent higher rate to a newly formed foreign subsidiary of the same parent.[83] The new subsidiary then lent back the same amount to the parent.[84]

Revenue Ruling 76-192 collapsed the two steps of the transaction and held that the foreign subsidiary selling the debt obligations had invested in U.S. property because it indirectly held the obligation of the domestic parent.[85] In reaching this conclusion, the Ruling charac-

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76. *See* Rev. Rul. 84-152, 1984-2 C.B. 383. The Ruling does not state whether the parent guaranteed the interest and principal on the obligations of the foreign finance subsidiary, the usual case in foreign finance subsidiary arrangements. Assuming such an arrangement, the Service should have discussed this fact to bolster its position that the Antilles subsidiary was a sham. In any event, stable corporate giants often issue debt instruments through Antilles subsidiaries, so even without an express guarantee, foreign bondholders may rely on the goodwill and financial backing associated with the parent corporation.

77. Rev. Rul. 84-153, 1984-2 C.B. 383, 383.

78. *See* Cole & Misher, *supra* note 3, at 266; Fogarasi & Renfroe, *supra* note 3, at 446.

79. Rev. Rul. 76-192, 1976-1 C.B. 205.

80. Specifically, this Ruling considered whether the loan made by a newly formed foreign subsidiary to its domestic parent qualified under I.R.C. § 956 as an investment by another foreign subsidiary in U.S. property. Rev. Rul. 76-192, 1976-1 C.B. 205.

81. *Id.* at 205.

82. *Id.*

83. *Id.*

84. *Id.*

85. *Id.*

terized the financial institution that kept the 1 percent interest spread as "acting . . . as a mere conduit" because it independently would not have made the loan to the second subsidiary.[86] This language is similar to that of *Revenue Rulings 84-152* and *84-153.*

Revenue Ruling 76-192 indicates that a 1 percent interest spread may not be sufficient to overcome the *Aiken Industries*' conduit theory. Moreover, the facts of *Revenue Ruling 84-152* present an even stronger case for disregarding a corporate entity than the facts of *Revenue Ruling* 76-192. An unrelated foreign financial institution was involved in *Revenue Ruling* 76-192, while in *Revenue Ruling 84-152* all three parties to the transactions were related.[87] *Revenue Ruling* 76-192 did not find a tax avoidance motive for the form of the transaction, while *Revenue Ruling* 84-152 noted such a motive. Furthermore, in *Revenue Ruling* 76-192 two steps of the transaction were collapsed. Revenue Ruling 84-152 collapsed just one step. Finally, *Revenue Ruling* 84-152 indicated that the Antilles subsidiary was "not sufficiently liquid to make the loan to [the Antilles subsidiary] out of funds other than those obtained from [the parent corporation]."[88] This final factor connotes that the Antilles subsidiary lacked autonomy from the parent corporation.

Conversely, *Revenue Ruling 84-153* presents a weaker case for disregarding a subsidiary than either *Revenue Ruling* 76-192 or *Revenue Ruling 84-152.* In *Revenue Ruling 84-153,* unrelated foreign bondholders were the ultimate borrowers and, presumably, the Antilles subsidiary was sufficiently liquid to make the loan to the U.S. subsidiary without first receiving the funds from the foreign bondholders.[89]

6. *The 1 Percent Interest Differential: Risk of Loss Analysis*

A 1 percent interest differential may not be a sufficient business activity for concluding that a related entity has a separate identity. Because the 1 percent interest spread is guaranteed regardless of fluctuations in market rates, the Antilles subsidiaries in *Revenue Ruling 84-152* and *Revenue Ruling 84-153* did not bear the risk of changing market conditions.

Revenue Ruling 78-118[90] held that the party deemed the true

86. *Id.*
87. *See supra* note 72.
88. Rev. Rul. 84-152, 1984-2 C.B. 381, 382.
89. This assumption is reasonable because Revenue Ruling 84-153, issued simultaneously with Revenue Ruling 84-152, which indicated the Antilles subsidiary was not sufficiently liquid, did not state otherwise. Rev. Rul. 84-153, 1984-2 C.B. 383.
90. Rev. Rul. 78-118, 1978-1 C.B. 219.

obligee on the transaction was the party that bore the risk of loss.[91] In that Ruling, the U.S. government's Export-Import Bank served as an intermediary in a loan agreement between a foreign corporation and a U.S. commercial bank.[92] The foreign corporation paid a flat rate of 8 percent interest to the Export-Import Bank on its promissory note.[93] The Export-Import Bank agreed to pay the commercial bank interest on its disbursed funds at a rate of .05 percent above the commercial bank's minimum commercial lending rate.[94]

The Ruling held that the two agreements were distinct. In reaching this conclusion, the Ruling noted that neither transaction involved all three parties, that each agreement called for a separate interest rate, and that the interest rates were unrelated.[95] Moreover, the Export-Import Bank could make a profit on the spread between the interest payable and the interest receivable, or it could suffer a loss depending on market conditions.

Revenue Ruling 84-152 is distinguishable from *Revenue Ruling* 78-118. First, the flat 1 percent interest spread suggests that the two interest rates were related. Second, the transaction guaranteed the Antilles subsidiary a gross profit of 1 percent without liability for possible economic loss. Finally, in *Revenue Ruling 84-152*, the Antilles subsidiary could not make the loan to the U.S. subsidiary independently of the parent for lack of sufficient liquidity; thus, the ultimate risk of loss rested with the parent. Based on the standards provided by *Revenue Rulings* 76-192 and 78-118, *Revenue Ruling 84-152* correctly treated the loan from the parent to the Antilles subsidiary and then to the domestic subsidiary as one transaction, thus disregarding the intermediary corporation.

Revenue Ruling 84-153 is a harder case. Even though the Antilles subsidiary could not suffer loss on the transaction, the foreign bondholders were unrelated to the ultimate borrower. The Antilles subsidiary presumably did not require the funds from the foreign bondholders before it made the loan to the U.S. subsidiary.[96] Although it is unlikely that the Antilles subsidiary was engaged in a business activity as defined above, these factors may outweigh the lack of business activity.[97]

91. *Id.* at 220.
92. *Id.* at 219.
93. *Id.*
94. *Id.*
95. *Id.* at 220.
96. *See supra* note 89.
97. A 1 percent interest differential may be viewed from a different perspective. When this differential constitutes the only profit a foreign corporation earns on funds passing through its jurisdiction, the payment may be a royalty rather than interest income. If it is treated as a royalty, then article VIII(1) of the United States-Antilles Treaty would not

7. *Substantial Business Purpose*

Assuming that the 1 percent interest differential retained by the Antilles subsidiaries in *Revenue Rulings 84-152* and *84-153* does not qualify as a "substantive business activity," a substantial business purpose for the transaction must exist to recognize the Antilles subsidiary as a separate entity. The prevailing view is that a tax avoidance motive can exist if the transaction's primary purpose is some legitimate motive other than tax avoidance.[98] Even a corporation formed for a limited purpose may qualify as a separate taxable entity if it carries out that purpose.[99] The relevant question in an analysis of *Revenue Rulings 84-152* and *84-153* is whether some legitimate business purpose for the form of the transactions outweighs any tax avoidance motive.[100]

The mere existence of a financial intermediary in a tax haven jurisdiction does not require disregarding the financial intermediary.[101] In *Hospital Corp. of America v. Commissioner*,[102] the Tax Court held that the formation of a foreign subsidiary in the Cayman Islands, a tax haven jurisdiction, was not a sham.[103] The subsidiary

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have applied to the payments; rather, the Tax Treaty provision relating to royalties would have applied. Article IX of the United States-Antilles Treaty, which pertains to royalties, provides:

> Royalties for the right to use copyrights, patents, designs, secret processes and formulae, trademarks, and other analogous property, and royalties, including rentals, in respect of motion picture films or for the use of industrial, commercial or scientific equipment, derived from sources within one of the contracting states by a resident or corporation of the other contracting state not engaged in a trade or business in the former state through a permanent establishment, shall be exempt from tax imposed by the former state.

See United States-Netherlands Income Tax Treaty, *supra* note 24, art. IX.

Because article IX of the Treaty does not enumerate the kind of payment involved in Revenue Rulings 84-152 and 84-153, the Service probably would not treat the payment as exempt from U.S. taxation. If a particular tax treaty's royalty provision includes such a payment, this issue may favor the taxpayer.

98. The Fifth Circuit stated:

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

Britt v. United States, 431 F.2d 227, 235 (5th Cir.1970) (quoting National Investors Corp. v. Hoey, 144 F.2d 466, 468 (2d Cir. 1944)).

99. *See, e.g.*, Siegel v. Commissioner, 45 T.C. 566, 576-77 (1966) (Florida food broker formed a Panamanian corporation for the purpose of investing in a joint venture to conduct farming operations in Cuba).

100. *See supra* note 5.

101. *See infra* note 102 and accompanying text; *see also* Rev. Rul. 75-118, 1975-1 C.B. 390 (the Service did not prevent the operation of the United States-Antilles Treaty where an Antilles holding company received dividends from a wholly-owned American subsidiary).

102. 81 T.C. 520 (1983).

103. *Id.* at 583-84.

actually carried on a minimal amount of business activity.[104] The court noted that factors other than the tax benefits could have influenced Hospital Corp. of America's ("HCA") decision to form the subsidiary in the Cayman Islands. For example, the court pointed to the "use of English language, the familiar English law principles on which Cayman Islands corporate law is based, the stability of the government, and the ease of communication and transportation between . . . headquarters of HCA in the United States and the Cayman Islands."[105]

The Antilles provides similar non-tax advantages over other jurisdictions for the formation of foreign finance subsidiaries. Although Dutch is the official language, English is an accepted language for international business transactions.[106] Incorporation in the Antilles is usually inexpensive and can be accomplished quickly and easily.[107] The Antilles possesses a relatively stable political and economical environment,[108] and its developed air and shipping routes connect Europe and the United States with South America.[109] In addition, the Antilles' established banking system provides both local and international services.[110]

These factors alone may not outweigh the lack of substantial business activities in *Revenue Ruling 84-152*. Both the ultimate lender and borrower were members of the same controlled group. Furthermore, the Antilles subsidiary could not have made the loan to the U.S. subsidiary without first receiving the funds from the parent corporation.[111]

The analysis of *Revenue Ruling 84-153* is less clear because the form of the transaction may have been economically favorable for non-tax business reasons.[112] In *Gregory*, the Supreme Court stated that a taxpayer may adopt any lawful form of business to conduct its operations.[113] Subsequent cases, however, tend to require some kind of general plan of expansion or natural division of corporate functions

104. *Id.* at 586.

105. *Id.* at 583.

106. Diamond & Diamond, *supra* note 16, at 18.6.

107. *Id.* at 18.7.

108. *Id.* This premise has been questioned since August 1977, when Aruban workers staged a strike to call attention to their desire for independence from the Antilles. More recently, economic pressures and unemployment have led to increased unrest in several islands that comprise the Antilles. *Id.* at 17-18.1.

On January 1, 1986 Aruba gained separate status from the six-island federation known as the Antilles. *Id.* at 20.4-.5.

109. *Id.* at 18.1-.2.

110. *Id.* at 18.3-.5.

111. Rev. Rul. 84-152, 1984-2 C.B. 381, 382; *see also supra* text accompanying note 88.

112. *See infra* notes 113-22 and accompanying text.

113. Gregory v. Helvering, 293 U.S. 465, 467 (1935); *see also* Britt v. United States, 431 F.2d 227, 234 (5th Cir.1970).

for recognition of the separate identity of a foreign finance subsidiary established in a tax haven jurisdiction.[114] For example, in *Hospital Corp. of America*, HCA formed the foreign subsidiary in the Cayman Islands as part of a general plan of expansion into foreign jurisdictions with the Cayman Islands subsidiary being responsible for conducting the foreign operations of HCA.[115] In *Revenue Ruling 84-153*, however, the Antilles subsidiary loaned money to a U.S. subsidiary and not to another foreign subsidiary of the parent corporation.[116] Therefore, the plan lacked the "natural" foreign or domestic division that the court recognized as a legitimate business purpose in *Hospital Corp. of America*.[117]

Courts and the Service have recognized other business justifications for utilizing foreign subsidiaries. In *Siegel v. Commissioner*,[118] the Tax Court found that petitioner's desire to keep a domestic produce business separate from a farming venture in Cuba constituted a legitimate motive for forming a Panamanian corporation. *Revenue Ruling* 75-23[119] accepted the use of a corporation because foreign investors preferred a corporation over a limited partnership as an investment vehicle because the investors were unfamiliar with a limited partnership.[120]

Revenue Ruling 84-153 implies equally compelling business justifications for using the Antilles subsidiary to issue bonds to foreign investors. First, the parent corporation claimed its purpose for using the Antilles subsidiary was to obtain the lower interest rates available on the foreign bond market. Although the subsidiary could have issued the bonds directly after July 18, 1984, without the imposition of withholding taxes, the reporting requirements may have caused the transaction to be expensive and unattractive. Second, issuing the bond through the Antilles may have attracted foreign investors seeking secrecy in the Antilles. Third, the business of issuing bonds may have differed substantially from the corporate activities of the U.S. subsidiary that ultimately received the proceeds from the bond sale. Fourth, if the Antilles subsidiary engaged in many such transactions, the volume of activity could have resulted in economies of scale. Fifth, the Antilles subsidiary may have been employed because it was financially

114. *See* Hospital Corp. of Am. v. Comm'r, 81 T.C. 520 (1983); Ross Glove Co. v. Comm'r, 60 T.C. 569, 588 (1953).

115. *Hospital Corp. of Am.*, 81 T.C. at 581.

116. *See supra* notes 19-22 and accompanying text.

117. *Hospital Corp. of Am.*, 81 T.C. at 582.

118. 45 T.C. 566 (1966).

119. Rev. Rul. 75-23, 1975-1 C.B. 290.

120. *Id.* at 291; *see also* Ross Glove Co. v. Comm'r, 60 T.C. 569 (1973) (recognizing a Bahamian corporation where petitioner formed the corporation primarily to conduct a Philippine glove manufacturing operation).

stable and could issue the bonds to foreign investors without guarantees from the parent corporation.[121] Another corporation may have lacked such financial stability. Thus, for business reasons, using the Antilles subsidiary may have been a convenient and practical way to structure the transaction. Finally, the transaction lacked one of the features of many "sham" transactions because the Antilles subsidiary was not formed specifically to engage in this transaction, but had existed since 1982.[122]

These justifications may not be as compelling as those in *Siegel* and *Revenue Ruling* 75-23 because the choice was not between corporate form and an individual proprietorship or a limited partnership.[123] When aggregated, however, they present a viable argument for recognizing the separate identity of the Antilles subsidiary in *Revenue Ruling 84-153*. Although the Ruling does not recite all the facts relevant to making such a determination, the facts presented do suggest that under the traditional separate identity doctrine of "substantive business activity or substantial business purpose" the Revenue Ruling should have recognized the Antilles subsidiary.

8. *Summary of Separate Tax Identity Arguments*

The holding in *Revenue Ruling 84-152* is consistent with precedent disregarding a separate identity. *Revenue Ruling 84-152* provides a clear standard for avoiding "sham" treatment. A fixed percentage-point interest spread cannot overcome the conduit nature of a loan agreement made through a foreign finance subsidiary when both the ultimate lender and borrower are members of the same controlled group, or when the financial intermediary making the loan cannot do so without first receiving the funds from another member of the controlled group.[124]

Revenue Ruling 84-153, however, presents a murky standard for planners and is likely incorrect. The Ruling's facts differ sufficiently

121. *See supra* note 76.

122. *See, e.g.*, Gregory v. Helvering, 293 U.S. 465 (1935); Johansson v. United States, 336 F.2d 803 (5th Cir. 1964).

123. The limited liability of corporations, as well as other desirable non-tax features, may justify the choice of corporate form over another business. The choice in Revenue Ruling 84-153 may have been between direct issuance of a bond and indirect issuance financing through the Antilles subsidiary; or, more likely, between issuing a bond through the domestic market having higher interest rates, or through an Antilles subsidiary on a foreign bond market having lower interest rates. The latter choice, with its tax and other economic advantages, is preferable.

124. The above analysis indicated that a fixed percentage-point interest differential may never be sufficient to overcome the conduit theory. A variable interest rate seems to be safer. *See supra* text accompanying notes 90-95. In addition, under a particular treaty, treating the payment as a royalty may result in its being exempt from withholding taxes. *See supra* note 97.

from those in *Aiken Industries* to cast doubt on the conclusion that the Antilles subsidiary was "merely a conduit" for the passage of interest payments to the foreign bondholders without some further explanation for such an assertion. Neither the ultimate borrower nor the parent corporation controlled the foreign bondholders. In addition, the facts and circumstances of the bond offered do not support the language in the Ruling stating that the Antilles subsidiary "lacks sufficient business or economic purpose to overcome the conduit nature of the transaction."[125] The form of the transaction reflects compelling business justifications.

B. Tax Treaty Interpretation

In addition to the issue of when it is appropriate to disregard the separate identity of a corporation, the Revenue Rulings also raise the issue of how to interpret international tax treaties. In particular, *Revenue Rulings 84-152* and *84-153* require consideration of how to interpret specific language in a tax treaty and how to interpret generally a treaty in light of the contracting parties' intentions.

1. *Interpretation of the "Derived . . . By" Language of Article VIII(1)*

An essential element of both *Revenue Ruling 84-152* and *Revenue Ruling 84-153* is the interpretation of the "derived . . . by" language of article VIII(1) of the United States-Antilles Treaty.[126] The interest payments were subject to withholding tax through the interpretation of such treaty language. Specifically, the Rulings interpreted the words "derived . . . by" as implying "complete dominion and control over the funds."[127] The general canons of treaty interpretation do not support this finding.

It is well-settled that international tax treaties should be construed liberally to effect the intent of the parties.[128] Specific words of a treaty should be given a meaning that is consistent with the expectations of the contracting parties.[129] In addition, conventions of treaty interpretation require that ambiguous treaty language be construed "in a broad and liberal spirit . . . which prefers the favoring of rights

125. *See supra* notes 89, 96-97, 107-11, 112-22.

126. *See supra* text accompanying notes 24-29.

127. Rev. Rul. 84-152, 1984-2 C.B. 381, 381; Rev. Rul. 84-153, 1984-2 C.B. 383, 383-84.

128. *See, e.g.*, Maximov v. United States, 373 U.S. 49, 52 (1963) (court should not read the language or conceive the purpose of a treaty different from normal word usage or domestic tax concepts); *see also* Jordan v. Tashiro, 278 U.S. 123, 127 (1928) (principles controlling diplomatic relations and treaties require that obligations be liberally construed to effectuate the intention of the parties to secure equality and reciprocity).

129. Johansson v. United States, 336 F.2d 803, 813 (5th Cir.1964) (citing Maximov v. United States, 373 U.S. 49, 56 (1963)).

granted under it over a restrictive view of those rights."[130] A desire to minimize taxes does not require automatic denial of a treaty benefit.[131] Limiting the "derived . . . by" language in article VIII(1) of the United States-Antilles Treaty to imply "complete dominion and control over the interest payment," runs contrary to the foregoing general norms of treaty interpretation.[132]

In addition to not following the canons of treaty interpretation, *Revenue Rulings 84-152 and 84-153* used an overly broad definition of the treaty language, "derived . . . by." The Rulings stated that such language implies "complete dominion and control" over the interest payment. Financial intermediaries of all types, including banks, generally use the payments received from one customer to provide funds for another customer. The Rulings could be construed to mean that for tax purposes any financial intermediary should be disregarded for lack of "complete dominion and control" over the funds it borrows and relends.[133]

Although the words "lack complete dominion and control over the funds" may have some factual justification in *Revenue Ruling 84-*

130. Estate of Burghardt v. Comm'r, 80 T.C. 705, 708 (1983) (quoting Samann v. Comm'r, 36 T.C. 1011, 1014-15 (1961), *aff'd*, 313 F.2d 461 (4th Cir.1963)); *see also* Factor v. Laubenheimer, 290 U.S. 276, 293 (1933); Jordan v. Tashiro, 278 U.S. 123 (1928).

131. Compagnie Financiere de Suez et de L'Union Parisienne v. United States, 492 F.2d 798, 810 (Ct.Cl. 1974) (citing Gregory v. Helvering, 293 U.S. 465 (1935)); Johansson v. United States, 336 F.2d 803, 809 (5th Cir. 1964).

132. *But see* Aiken Indus. v. Comm'r, 56 T.C. 925, 933 (1971) (the Tax Court similarly limited the "received . . . by" language of article IX of the United States-Honduras Treaty). For a discussion of *Aiken Industries*, see *supra* notes 61-71 and accompanying text.

With general treaty interpretation norms favoring a more liberal meaning for "derived . . . by," the Service might have relied on one notable limitation to this standard. Courts have held that a treaty should not be interpreted so as to sweep within its protection taxpayers not clearly intended as beneficiaries. Maximov v. United States, 373 U.S. 49, 56 (1963); *Compagnie Financiere*, 492 F.2d at 810-11; *Johansson*, 336 F.2d at 813. This restriction may apply to Revenue Rulings 84-152 and 84-153 because the Rulings limit use by third party investors of the United States-Antilles Tax Treaty. An analysis of cases that have employed the above limitations, however, reveals that such an application would be stretching the reasoning in existing precedent. In general, courts have used this theory to determine, under U.S. tax law principles, which corporations and individuals can be the beneficiaries of a tax treaty. *See Maximov*, 373 U.S. at 49 (concluding that a U.S. trust whose beneficiaries were British subjects and residents was not a "resident of the United Kingdom"); *Compagnie Financiere*, 492 F.2d 798 (holding that the residence country of the Suez Canal Corporation, which had substantial connections to both France and Egypt, was Egypt); *Johansson*, 336 F.2d 809 (concluding that Ingmar Johansson was not a resident of Switzerland merely because Swiss tax authorities considered him such).

Revenue Rulings 84-152 and 84-153, however, did not question whether the Antilles corporation fell within the purview of the treaty. Rather, they used the general, "derived . . . by" language of the treaty to limit its application. In effect, the Rulings applied the rubric that a tax treaty should not be construed so that citizens and residents of nonsignatory nations can benefit from it. However, the above precedents do not require such a reading.

133. For a discussion of treaty interpretation in *Aiken Industries*, see James, *supra* note 3, at 142-44.

152, that justification is weaker in *Revenue Ruling 84-153.* The court in *Aiken Industries* stated that the phrase "complete dominion and control" means received "as its own and not with the obligation to transmit it to another."[134] In *Revenue Ruling 84-152,* the Antilles subsidiary lacked sufficient liquidity to make the loan payment to the domestic subsidiary independently of the loan it received from the parent. This fact supports an inference that the parent really controlled the funds and obligated the Antilles subsidiary to lend the funds to the domestic subsidiary. Thus, in *Revenue Ruling 84-152,* the Antilles subsidiary most likely lacked "complete dominion and control" over the interest payment.

In contrast, the Antilles subsidiary in *Revenue Ruling 84-153* received from foreign bondholders the funds that it subsequently lent to the U.S. subsidiary. Neither the U.S. subsidiary nor the U.S. parent controlled the bondholders. The Ruling does not indicate that the bonds were issued contingent on re-lending the proceeds. Conceivably, the Antilles subsidiary could have invested the proceeds in some other venture. Therefore, no obligation existed to transmit the funds to the U.S. subsidiary. As a result, the facts of *Revenue Ruling 84-153* do not support a finding that the Antilles subsidiary lacked "complete dominion and control" over the interest payment.

An additional problem with the definition applied to "derived . . . by" in the subject Revenue Rulings is that this definition has the effect of producing a bias against the United States-Antilles Treaty (and possibly other treaties that use similar language), in conflict with the intentions of the contracting parties.[135]

2. *Purpose and Intent of the United States and Netherlands Antilles with regard to Article VIII(1) of the Treaty*

Given the liberal treaty interpretation standard, the goal of treaty interpretation should be to "apply general language to specific facts in light of the drafters' intentions."[136] Generally, the purposes of bilateral tax treaties are to avoid double taxation; to remove obstacles to the flow of trade and investment between the two signatories;[137] and to prevent fiscal evasion.[138] When the legislative history of a treaty or the language used in a treaty reveals that the parties had specific inten-

134. *Aiken Indus.,* 56 T.C. at 933.
135. *See* Cole & Musher, *supra* note 3, at 268-70.
136. Osgood, *Interpreting Tax Treaties in Canada, the United States, and the United Kingdom,* 17 CORNELL INT'L L. J. 255, 296 (1984).
137. Maximov v. United States, 373 U.S. 49, 54 (1963); Compagnie Financiere de Suez et de L'Union Parisienne v. United States, 492 F.2d 798, 810 (Ct. Cl. 1974); Johansson v. United States, 336 F.2d 803, 813 (5th Cir. 1964).
138. *Maximov,* 373 U.S. at 54.

tions in enacting or modifying certain treaty articles, courts should look to relevant documents that reveal such specific intentions. The holding of a case or ruling should not contradict the parties' stated intentions.

The United States-Netherlands Protocol Modifying and Supplementing Income Tax Convention (the "Protocol") amending the United States-Antilles Treaty,[139] and the Treasury Department's statement with respect to the Protocol[140] reveal the specific intentions behind article VIII(1). The Protocol's purpose was to increase the U.S. tax rate on dividends, interest, and royalties received from U.S. sources by Antilles investment companies owned by persons who are not residents of the Netherlands or Antilles.[141] Paragraph (1) of article I provided that article VIII(1) of the convention

> shall not apply to income derived from sources within the United States by any investment or holding company, . . . or other entity entitled to any of the special tax benefits provided under Article 13, Article 14, or Article 14A of the Netherlands Antilles National Ordinance on Profit Tax of 1940 . . . or to substantially similar tax benefits granted under any law of the Netherlands Antilles . . . .[142]

Articles 13, 14, and 14A provide a special reduced corporate tax rate of 2.4 to 3.0 percent.[143]

Significantly, the Protocol was not intended to limit the reductions in statutory tax rates on dividends, interest, and royalties paid to corporations of the destination country to residents of the Netherlands or Antilles. Rather, the Protocol was ratified to reduce the benefits of the United States-Antilles Treaty to third country investors.[144]

The Protocol's legislative history indicates that the Treasury Department did not take a negative view of third country investors who take advantage of the United States-Antilles Tax Treaty:

> [W]hen residents of third countries are lured into holding their U.S. investments in a company incorporated in a treaty country through artificial reduction by that country of its own tax rates on the income, the primary purpose of a tax treaty is subverted. Tax treaties are governmental agreements designed to prevent double (and therefore excessive) taxation of an investor's foreign-

139. Protocol Modifying and Supplementing Income Tax Convention, October 23, 1963, United States-Netherlands, 15 U.S.T. 1900, T.I.A.S. No. 5665 [hereinafter The Protocol].

140. United States Treasury Department's statement regarding the 1963 Protocol, 1965-1 C.B. 664 [hereinafter Treasury Department Statement].

141. The Protocol, *supra* note 139.

142. The Protocol, *supra* note 139, art. I, para. (1).

143. The regular corporate tax rate in the Antilles ranges between 24 and 30 percent. Treasury Department Statement, *supra* note 140, at 668. However, special Antillean tax rates exist for investment and holding companies. *Id.* at 669. Thus, prior to the Protocol, the maximum effective tax burden for Antilles investment companies and holding companies on investment income derived by a Antilles corporation from U.S. sources was 3 percent. *Id.*

144. *Id.*

> source income by resolving conflicting jurisdictional claims to tax which arise because one country is the source of the income and the other is the residence of the recipient. Exemptions and reductions in source taxation provided for by treaty are reciprocal revenue adjustments between governments designed to implement a tax credit for foreign taxes paid. They are not intended to reduce the tax burden of the investor, as it is assumed that the tax waived by the source country will be imposed by the destination country.[145]

This statement indicates the Treasury Department's belief that if the Antilles subsidiary paid the regular Antilles corporate tax rate, then the benefits of the United States-Antilles Treaty would be available to third country investors.

The United States and the Antilles considered curtailing all treaty benefits to third country investors when negotiating the Protocol. However, this action would have been less favorable to the United States than the solution the Protocol eventually reached.

> In recommending ratification of article I of the protocol, the Treasury continues to recognize the desirability of encouraging foreign portfolio investment in the United States during our present imbalance of international payments. To this end, *care has been taken not to remove from the treaty those provisions (such as the exemption of Netherlands Antilles corporations from the so-called "secondary tax" on dividends and interest paid by them to persons other than U.S.persons) which have long been an intended benefit of the United States treaty program.*[146]

These statements indicate that the United States encouraged third country investment in the Antilles, provided that the special reduced tax benefits were not available to such third country residents.

Revenue Rulings 84-152 and *84-153* state that such special tax benefits did not apply to the Antilles subsidiaries.[147] In light of the Protocol and the Treasury Department statement regarding the Protocol, *Revenue Rulings 84-152* and *84-153* are inconsistent with the intent of the contracting parties. The Rulings have the effect of limiting the use of the United States-Antilles Treaty by persons from third countries in a way specifically rejected by the Protocol.[148]

It appears that what the Service really objected to was not the form of the transaction, but the fact that the foreign bondholders, who

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145. *Id.*

146. *Id.* (emphasis added).

147. Rev. Rul. 84-152, 1984-2 C.B. 381, 382; Rev. Rul. 84-153, 1984-2 C.B. 383, 383.

148. *See* Cole & Musher, *supra* note 3, at 270-71. This analysis is supported by the following analogy. Article VII(1) of the United States-Antilles Treaty, which allowed for a reduction in the dividend withholding tax from 15 percent to 5 percent, provided that "such reduction of the rate shall not apply if the relationship of the two corporations has been arranged or maintained primarily with the intention of securing such reduced rate." United States-Netherlands Income Tax Treaty, *supra* note 24, art. VII(1). Revenue Ruling 79-65, 1979-1 C.B. 458, held that the domestic corporation must provide information, when requested by the Service, to establish that its relationship with its Antilles parent was not arranged, or maintained, primarily with the intent of securing the reduced rate. *Id.* Thus, art. VII(1) and the above Revenue Ruling indicate that if the Treasury Department wanted to limit the application of art. VIII(1), it knew how to accomplish this objective.

were neither citizens of the Netherlands nor the Antilles, received the tax benefits of a treaty to which their home nations were not parties. Renegotiation of the Tax Treaty, as provided in article XXV(2) of the Treaty, would have been a more forthright method of curbing this perceived abuse.[149]

C. UNILATERAL TREATY OVERRIDE

Revenue Rulings 84-152 and *84-153* may affect not only transactions between the United States and the Antilles, but also relations with other countries with which the United States maintains bilateral tax treaties. This broad effect reflects in part the fact that the Revenue Rulings imputed the requirements necessary for nonapplication of withholding taxes under code sections 871(h) and 881(c) to the United States-Antilles Treaty. In doing so, the Ruling unilaterally overrode the existing treaty even though Congress did not mandate such a result in enacting the 1984 Act.[150]

Although U.S. tax treaties are not statutes, "they have equal dignity with statutes under the Constitution."[151] Accordingly, the Code provides that its provisions shall not apply when they are contrary to existing treaty obligations.[152] Code section 894(a) establishes the supremacy of treaty tax exemptions.[153] A treaty may be modified by a subsequent act of Congress.[154] Nevertheless, when a treaty and a statute relate to the same subject, courts will attempt to interpret them so as to give effect to both.[155] Subsequent legislation should not be interpreted to modify an earlier treaty unless it is clearly Congress' intent.[156]

With regard to the instant Revenue Rulings, there is no evidence that Congress intended to impute U.S. tax treaties in general, or the United States-Antilles Treaty in particular, with the reporting require-

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149. Article XXV(2) of the United States-Antilles Treaty provided: "Should any difficulty or doubt arise as to the interpretation or application of the present Convention, the competent authorities shall undertake to settle the question by mutual agreement." *See* United States-Netherlands Income Tax Treaty, *supra* note 24, art. XXV(2).

150. *See* Fogarasi & Renfroe, *supra* note 3, at 444-45.

151. Osgood, *supra* note 136, at 263.

152. I.R.C. § 7852(d) (CCH 1986).

153. I.R.C. § 894 (a) provides that "[i]ncome of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle." *Id.* § 894(a).

154. *See, e.g.*, Head Money Cases, 112 U.S. 580, 599 (1884); Estate of Burghardt v. Comm'r, 80 T.C. 705, 713 (citing Moser v. United States, 341 U.S. 41, 45 (1951)).

155. *Burghardt*, 80 T.C. at 713 (citing Whitney v. Robertson, 124 U.S. 190, 194 (1888)).

156. *Id.*; *see* I.R.C. §§ 897(i), 269B(d) (CCH 1986). These two I.R.C. sections evidence clear intent to abrogate treaty obligations. *See also* Langer, *Override of Tax Treaties by Ordinary Legislation*, 34 BULL. FOR INT'L FISCAL DOCUMENTATION 552 (1980).

ments called for in the repeal sections.[157] Therefore, the Treaty withholding tax exemption should prevail regardless of the repeal.

Since the Code's repeal provisions were imputed into article VIII(1) of the Treaty, the treaty provided no benefit to taxpayers not otherwise available under the Code. The contracting parties intended article VIII(1) to provide benefits not available under U.S. tax law in an attempt to facilitate commerce and improve the United States' balance of payments problem.[158] Therefore, the Rulings are contrary to the intent of the United States and the Antilles in enacting article VIII(1) of the Treaty.

The Service issued *Revenue Rulings 84-152* and *84-153* after the repeal of withholding taxes on portfolio interest. The Service knew that its action would lead to direct investment in foreign debt instruments rather than investment through Antilles subsidiaries.[159] Because the actions of individuals and corporations are not always predictable, the Rulings might well have adversely affected the Antilles' economy.[160]

Finally, the Service issued the Rulings after the United States encouraged the use of foreign finance subsidiaries in the Antilles to alleviate the United States' imbalance of payments.[161] The abrupt change of policy in *Revenue Rulings 84-152* and *84-153* may prove detrimental not only to relations with the Antilles, but also to tax treaty negotiations with other countries. Countries viewing this action may conclude that the United States only honors tax treaty obligations when beneficial to its own national interests and not when treaty partners rely on such obligations.[162] This action runs contrary to the general U.S. policy of discussing changes in its revenue posture with treaty partners before such changes are made,[163] and then phasing

157. *See, e.g.*, CONFERENCE REPORT ON THE DEFICIT REDUCTION ACT OF 1984, H.R. REP. NO. 861, 98th Cong., 2d Sess. (1984); JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., TAX TREATMENT OF INTEREST PAID TO FOREIGN INVESTORS (Comm. Print 1984); STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 2D SESS., EXPLANATIONS OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 416-24 (Comm. Print 1984).

158. *See supra* notes 136-49 and accompanying text.

159. Because of the favorable investment features of the Antilles, the Antilles government relied on the United States-Antilles Tax Treaty as a major source of its revenue. By 1984, an estimated 25 percent of Antilles governmental revenues were linked to the United States-Antilles income tax convention. Zagaris, *Congress Repeals the 30% Withholding Tax on Interest—Trouble for the Antilles*, 56 TAXES INT'L 18, 22 (June 1984).

160. *See supra* note 108 and accompanying text.

161. *See supra* notes 136-49 and accompanying text.

162. Continued approval of article VIII(1) of the Treaty would not have adversely affected the United States, especially in light of the repeal of the 30 percent tax on portfolio interest. *See supra* note 7 and accompanying text.

163. *But see* Rosenbloom, *Tax Treaty Interpretation*, 34 BULL. FOR INT'L FISCAL DOCUMENTATION 543, 545 (1980); *see also* Brockway, *Override of Tax Treaties by Ordinary Legislation*, 34 BULL. FOR INT'L FISCAL DOCUMENTATION 553, 554 (1980).

them in gradually.[164]

The Treasury Department began renegotiating the United States-Antilles Treaty in 1980 in an effort to stop perceived abuses of the Treaty.[165] This attempt was unsuccessful in part because of strong opposition from both U.S. citizens and the Antilles government.[166] Finally, on August 8, 1986, a new income tax treaty between the United States and the Antilles was signed.[167] The Tax Treaty should have been renegotiated before the Service embarked on the drastic course outlined in *Revenue Rulings 84-152* and *84-153*.

V. CONCLUSION

The holding of *Revenue Ruling 84-152* is correct despite its faulty analysis. An analysis of the precedents dealing with the separate identity of an entity would have yielded the same result. *Revenue Ruling 84-152*'s analysis should have been limited to factors such as the substantive business activity test, risk of loss, and substantive business purpose. There was simply no need for the Ruling to violate established treaty interpretation conventions and to unilaterally override an existing tax treaty. A fixed percentage-point interest spread is not sufficient business activity to meet the substantive business activity test. This activity involved no apparent risk of loss. A substantive business purpose for using a foreign finance intermediary is not evident when the ultimate lender and ultimate borrower are members of the same controlled group and the intermediary does not independently possess sufficient funds to make the loan without first receiving the capital from another member of the controlled group.

Revenue Ruling 84-153 presents a harder case. Unfortunately, the Ruling does not provide adequate facts to conclude positively that the Antilles subsidiary was engaged in a substantive business activity or was formed for a substantial business purpose. The facts presented, however, support the conclusion that the Ruling was incorrectly decided based on the precedents underlying the separate identity doctrine, general canons of treaty interpretation, and the legislative history of the 1963 Protocol.

Finally, the Service issued these Rulings without consulting or considering the possible economic impact on the Antilles. This is a dangerous precedent and bad policy, especially when dealing with gov-

164. *See* Brockway, *supra* note 163; Langer, *supra* note 156. The Code changes provided in I.R.C. §§ 897,269B (CCH 1986) and the 1963 Protocol were phased in gradually.

165. Gelinas, *supra* note 5, at 242.

166. United States corporations feared losing access to the foreign bond market, and the Antilles government was concerned about loss of jobs and revenues directly attributable to the existing tax treaty.

167. *See supra* note 24.

ernments of small nations whose economies can be easily jolted by such abrupt policy changes. Therefore, courts and the Service should treat the standards and analyses used in *Revenue Rulings 84-152* and *84-153* as an aberration and accordingly should not follow them in the future.

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