The David R. Tillinghast Lecture
International Tax Arbitrage
and the
"International Tax System"

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I. INTRODUCTION

In 1986, a curious statement about international tax policy emanated from the Senate Finance Committee:

The committee does not believe that the United States Senate wittingly agreed to an international tax system where taxpayers making cross-border investments, and only those taxpayers, could reduce or eliminate their U.S. corporate tax through self-help and gain an advantage over U.S. persons who make similar investments.\(^1\)

At the time, the Committee was considering so-called "dual resident companies"—corporations whose losses might be used simultaneously to reduce taxable income of a related U.S. corporation and another related corporation in another country. The committee saw tax evil here, and its reaction and reasoning form the springboard for much of the discussion set forth below. The statement quoted above, however, is worthy of consideration in its own right.

More specifically: What, exactly, is this "international tax system" that the Committee invoked? Is it real? Currently functioning? The existence of overarching principles of international taxation into which U.S. law somehow fits, with which the U.S. Senate might be called upon to "agree," qualifies as news.\(^2\) Is there an imperative calling for some measure of international harmonization in matters of

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2 See Joseph Isenbergh, International Taxation: U.S. Taxation of Foreign Persons and Foreign Income, at xcix (2d ed. 1998) ("In a strict sense there is no international taxation. All taxes great and small are creatures of purely national tax laws.").
taxation, or should the Committee's comment be regarded as wishful thinking?

It may be useful to recall some first principles here. In U.S. eyes, a "tax" is a levy requiring a "compulsory payment pursuant to the authority of a . . . country to levy taxes" for which the payor receives no "specific economic benefit."\(^3\) In return for the payment of a tax, payors receive the general benefit of government. Clearly, it is possible to conceive of a tax in this sense that is wholly, or partially, arbitrary. A nation, for example, could effectively run a reverse lottery, choosing for assessment at random among persons subject to its jurisdiction. Less dramatically, it could adopt arbitrary deductions or credits based on educational level, geographical location, occupation, or any number of other attributes or actions of the taxpayer. Of course, most countries attempt to apply rules of taxation that are not arbitrary, at least in their view. And seemingly arbitrary elements in a tax system may reflect considerations that, on closer inspection, are not arbitrary at all.\(^4\)

Even without arbitrariness, a system of taxation necessarily operates on the basis of numerous detailed preconditions, the terms of which may—indeed, must—be expected to differ from country to country. Consider, for example, the income tax (as I will continue to do, throughout this Article). The income tax will not apply unless the nature of a given inflow is such as to qualify it as income, and often the operation of income tax rules will depend further upon the particular type, character, and source of the income. The person called upon to pay must be the person found responsible for the income, that is, the appropriate taxpayer. Issues relating to the status of that taxpayer—as resident, nonexempt, and the like—have to be considered. The responsibility of the taxpayer must arise within the time period for which the tax is imposed, and the circumstances must be such that the income has ripened and a liability to pay tax has been triggered. Entitlement to subtractions (deductions) in reaching the tax base is likely to depend on showing that outflows are correctly attributed to the taxpayer, that the deductions properly fall within the time period in question, and so on. There also may be credits for which a series of similar inquiries is necessary. Computational issues—how much income, how many deductions, how many credits—add to the list. All of these elements comprise the "stuff" of the tax.

\(^3\) Reg. § 1.901-2(a)(2).
\(^4\) Only non-Saudis are subject to the Saudi Arabian income tax, while Saudis pay the Zakat, a separate religious levy. [Saudi Arabia] Tax Laws of the World 1, 52-54 (1993). Is this arbitrary?
No one in the United States should be surprised that other jurisdictions have addressed these matters on their own terms and established rules that do not always match our own. The Germans do not have an exquisitely subdivided limitation on the foreign tax credit. The British assign corporate residence according to where an entity is managed and controlled, not only according to where it is organized. Japan does not have anything like the intricate U.S. rules for determining when a trust constitutes a taxpayer independent of either its grantor or its beneficiary. And few countries other than the United States are likely any time soon to draw the line between a taxable entity, on the one hand, and one whose income is taxable to its owners, on the other, on the basis of a choice exercised by the entity on a piece of paper.

Taxation under a rule of law (a concept not unique to the United States) depends upon a number of individual subrules, and there is nothing preordained or inevitable about what those subrules should be. The choices are plentiful, even if choices serving purposes other than the direct tax purpose are disregarded. It would be amazing if there was greater uniformity across national boundaries—if countries generally defined “resident” in the same way, or “corporation,” or “stock.” In fact, it is fairly amazing that the taxing jurisdictions of the world, with their diverse political and economic systems, have reached a point of sufficient understanding in matters of law and taxation that the concepts of “residence,” “corporation,” and “stock” are generally comprehensible almost everywhere.

We like to think that tax rules in the United States have been adopted and refined rationally and with at least a secular tendency toward economic soundness, administrability, and openness. But we hardly have a monopoly on correctness or consistency. It is not self-evident that a corporation organized under U.S. law but all of whose assets, personnel, and income are situated outside the United States should be taxable on worldwide income as a U.S. resident. Nor is the multi-factor formula that our courts employ to differentiate debt from equity derived from some immutable source. We cannot maintain with a straight face that we pursue substance while other countries look to form, since there are large areas of U.S. tax law (subchapter C, for one) where form largely triumphs over substance.

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5 [Ger.] Tax Laws of the World 120 (1993); see IRC § 904(d).
7 Compare IRC §§ 641-679.
8 See Reg. § 301.7701-2, -3.
9 See IRC §§ 11(a), (d); 7701(a)(4), (5).
Other nations pursue their own ways, for their own reasons. In many cases, a dispassionate analysis of those ways and reasons would conclude that they produce results at least as valid as the results we have reached in answering the same or similar questions. Can anyone doubt the force of a “managed and controlled” test for entity residence? We have opted for exclusive use of the more administrable place-of-incorporation standard, but we cannot realistically maintain that is because we are consistent in the choice of administrability over economic substance. If we were, we probably would have decided that the source of royalty income should be linked to the payor’s residence, as opposed to the far more cumbersome, but more economically accurate, place-of-use rule that we have adopted. Our criteria for distinguishing debt from equity may represent the ultimate pursuit of economic reality, but they are surely the bane of the tax administrator. In fact, we (like most other countries) have wandered about in our tax policy choices, sometimes favoring substance over form, and sometimes giving the nod to considerations of administrability. In some cases, we have vacillated, or provided rules that appeared clear at the outset but that subsequent developments rendered murky. And there are many instances where our rules have not remained under a firm policy-based control, particularly as the underlying factual inputs have mutated with advancing technology. Of course, other countries also face changing circumstances and, even if we were at the same point at any given time, there is little reason to believe we would remain there for long.

This all seems simple, obvious. Countries differ in regard to the many rules of law that make up any system of taxation. And, since taxpayers everywhere can be expected to try to keep their tax burdens to a minimum, it follows naturally that they will study the rules of individual countries and seek to turn them to their advantage. When taxpayers are engaged in cross-border business, the effort will involve a focus on differences in the applicable rules. Taxpayers that comply with all the rules, while benefiting to the maximum from each of them, will be the most successful at global tax minimization.

Certain implications of that minimization, and the focus on differences among countries, have been a source of concern for U.S. tax

\[^{11}\text{IRC § 7701(a)(4).}\]
\[^{12}\text{IRC § 861(a)(4).}\]
\[^{13}\text{See, e.g., Laidlaw, 75 T.C.M. (CCH) 2598, and decisions cited therein.}\]
\[^{15}\text{To all of the above should be added the limitations of language to describe all the potential variations of human action and inaction that the Code aims to cover. See generally Gustave Flaubert, Bouvard et Pécuchet (1880).}\]
policymakers in Congress, Treasury, and the Service. Yet, the basis for this concern is not clear and its justification seems questionable. That basis and that justification appear not to have received the examination they deserve.

II. THE ASCENDANCY OF "INTERNATIONAL TAX ARBITRAGE"

The implications of differences among country tax systems have come into sharp focus in recent years, especially following enactment of the Tax Reform Act of 1986. In part, this is because of a dramatic change in the most critical factor in U.S. international tax planning—the corporate tax rate. With the decline of that rate to 35%, the relative importance of other countries’ tax systems has increased commensurately. In addition, Congress gradually has limited opportunities to save taxes on income from cross-border economic activity by making creative use of the chinks in U.S. domestic law. Thus, several of the principal landmarks in planning for a U.S. multinational company, particularly the anti-abuse regime of subpart F, the transfer pricing rules, and the limitation on the foreign tax credit, have been tightened and refined, so that home-grown solutions for problems encountered abroad have become scarcer.

It is true that hordes of “investment bankers” still spend many hours scouring the Code and regulations for fault lines from which “structured products” can be developed. These efforts depend largely, if implicitly, upon the audit lottery, but they still can be highly rewarding. Even when the plans come to light, a court may be persuaded to adopt a reading of law that is either blind to what is going on, impervious to considerations of public policy, or both.

The effort to probe for weakness in the U.S. rules is not, however, dependable, because neither the Service nor the courts can be counted on to accept without protest the nuggets of planning material mined in the statutory and regulatory text. In addition to the threat posed by fill-in-the-blank statutory rules, such as § 7701(l) (relating obscurely to “any multiple-party financing transaction”), there are pesky nonstatutory doctrines that the planning often ignores, which can be in-

17 IRC § 11(a).
18 IRC §§ 951-964.
19 IRC § 482.
20 IRC § 904.
voked even when the rules seem clear. And problems can arise for even the best laid plans when implementation becomes slack and the concept underlying the plan (say, distinguishing stock from debt) is inherently problematic.

One result has been increasing taxpayer interest in "international tax arbitrage"—a lofty term that refers to taking advantage of differences among country tax systems, usually differences in addressing a common tax question. What is debt in Norway may be equity for us. If so, a distribution will be deductible interest for the Norwegian payor but a dividend bringing home foreign tax credits to the United States. A taxpayer may own depreciable property for U.S. purposes, while the counterparty to a transaction is the owner for Japanese tax purposes and therefore entitled to depreciation deductions under Japanese law. One airplane, two owners, two sets of deductions.

The list goes on. The United States sees one taxpayer, by reason of the check-the-box regime or otherwise; the other country sees two. We find ownership in one person, and a secured financing; they find a transfer of ownership to another person whom we perceive as a lender. We say the true borrower is the shareholder who guaranteed the debt; they say the debtor is the corporation that signed the loan instrument. The result is not a breach of U.S. rules, for there is no such breach (although the effort to meet foreign requirements may require massaging of facts, and in that process the application of U.S. law may pass from clear to arguable). The goal is to adhere, insofar as possible, to those rules while structuring the situation so as to meet the entirely different rules that obtain in the other country or coun-

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23 See, e.g., ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189 (1997), aff'd in substance, 157 F.3d 231 (3d Cir. 1998) (invoking substance-over-form doctrine to deny losses from transactions for which no nontax business purpose was found).


25 The term "arbitrage" can be used in the broader and more general sense of any item that gives rise to a deduction in one jurisdiction while the recipient in another jurisdiction is not found to have income. This usage underscores the vagueness of the arbitrage concept. In this essay, the term is generally used in the narrower sense.


27 See, e.g., Nebraska Dept. of Revenue v. Loewenstein, 513 U.S. 123 (1994); American Nat'l Bk. of Austin v. United States, 421 F.2d 442 (5th Cir. 1970), cert. denied, 400 U.S. 819 (1970); Rev. Rul. 74-27, 1974-1 C.B. 24. The cited authorities involve repurchase agreements or "repos," but substantially similar results have been achieved through securities loans and "usufructs."


29 See, e.g., Coleman v. Commissioner, 87 T.C. 178 (1986), aff'd, 833 F.2d 303 (3d Cir. 1987); see also Field Service Advice 199934009 (1999).
tries. If the effort is successful, tax benefits will flow in the United States and at least one other country.\textsuperscript{30}

This will result in obvious economic benefits beyond those that any single country having a tax interest in the transaction or situation would accord if the transaction or situation did not have a cross-border element. Potentially, the rewards are both richer and more secure than the effort to identify and exploit weaknesses in the tax laws of either the United States or the other country. As noted, we have attempted to discourage such exploitation in the United States, and other countries may have general anti-abuse rules ("abus de droit") that can be invoked when tax planning is viewed as going too far. The beauty of international tax arbitrage, when practiced most skillfully, is that none of the objections to aggressive or abusive tax planning should apply anywhere because, from the vantage point of any single country, there is neither aggressiveness nor abuse.\textsuperscript{31}

In its purest sense, the technique may be used to duplicate (in some cases, triplicate) tax benefits. The dual resident company and the double dip lease permit deductions to be claimed in more than one country. The unrelated income against which the deductions are applied is subject to tax in just one country; thus, a single transaction or arrangement gives rise to independent benefits in two or more countries. The same goal can be attained with imputation or foreign tax credits, which the laws of two or more countries may permit to be claimed independently in each country.\textsuperscript{32} In some cases, a different view regarding the nature of an instrument, and consequently, a payment, may allow different treatment in different tax jurisdictions; this is the case involving the dividend that another country perceives as an interest payment.\textsuperscript{33}

The most recent high-visibility example of international tax arbitrage was typical of this last type of transaction. Notice 98-11\textsuperscript{34} pertains to the exploitation of differing views of what is, and is not, a

\textsuperscript{30} There is, of course, no reason why the effort need involve the United States at all. Like so many other tax ideas that we have exported over the years, tax arbitrage can be put to use by foreign persons having no immediate or likely future U.S. tax involvement.

\textsuperscript{31} Consider, for example, this observation in Ltr. Rul. 9835011 (May 26, 1998), in which a cash dividend was recontributed to the capital of a foreign subsidiary pursuant to a preconceived plan: "Although the transaction is designed to achieve inconsistent tax characterizations under the income tax laws of the United States and the income tax laws of Country X, the intended results of the transaction are not inconsistent with the purposes of U.S. federal income tax law (including the bilateral income tax treaty with Country X)."

\textsuperscript{32} See Notice 98-5, 1998-3 I.R.B. 49.

\textsuperscript{33} It is also possible to string together various arbitrage elements, so that, for example, one country perceives in a given structure stock issued by entity \(X\) owned by entity \(A\) generating foreign tax credits while the other country finds debt issued by entity \(Z\) owned by entity \(B\) giving rise to interest deductions.

taxable entity; the check-the-box rules permit U.S.-based taxpayers to create entities recognized abroad whose existence the United States does not acknowledge (and, for that matter, vice versa). This tool easily gives rise to deductions allowable under foreign law with no commensurate income inclusion in the United States. The situations reported in Notice 98-11 are in this sense akin to situations in which a foreign country sees a deductible insurance premium while U.S. law finds no insurance and sees either a nontaxable distribution or a dividend carrying foreign tax credits with it.

There is an undeniable elegance to these arrangements. But elegance by itself is not a satisfactory reason for singling out these examples of tax arbitrage from other, more traditional forms of planning. If a foreign country allows a resident parent corporation to borrow and pay deductible interest, to use the borrowed funds to capitalize a subsidiary in a low-tax jurisdiction, and to have that subsidiary lend funds to a U.S. enterprise with no consequences in the home country of the parent (thus generating two interest deductions and only a single income inclusion, and that subject to a low tax rate), the effect would appear to be no different in substance from the dual resident company. More broadly, as long as the arbitrage hews to the rules in each affected country, it is hard to identify the difference between the more elegant examples and any situation in which a foreign country simply allows a tax benefit that the United States does not.

International tax arbitrage thus seems to flow seamlessly into the broader concept of reducing taxation worldwide as much as the laws of nations allow. The concept can be narrowed, but it is not clear that the narrowing achieves a meaningful analytical advance. And, although it may be observed that international tax arbitrage points in the direction of international nontaxation of income, that begs the issue. It implies that there is such a thing as international income, and that it is the task of someone—some nation—to ensure that tax applies to that income somewhere. (In all probability, this is one concept underlying the "international tax system" that the Senate Finance Committee invoked in 1986.) In fact, the longer one stares at recent examples of international tax arbitrage, the more difficult it becomes to identify a discrete subject. More troubling, the longer one performs this exercise, the less clear it is that anything should or can be done about it.

III. Is There a General Problem Here?

Congress apparently thinks—or, to be more accurate, at the time of the 1986 Act, it apparently thought—there is. That seems to be the meaning of congressional action and legislative history with respect to
dual resident companies addressed in § 1503(d). The 1986 experience is particularly interesting for present purposes, because the congressional materials on DRCs are far more explicit than any subsequent materials issued by Congress, Treasury, or the Service on any other example of international tax arbitrage.

The Senate Finance Committee, which initiated the congressional action in 1986, described the DRC issue as follows:

[A] corporation may be at the same time a U.S. resident and a resident of another country. Such companies are sometimes referred to as "dual resident companies." A dual resident company is taxable in both countries on its worldwide income (or it can deduct its worldwide losses). In addition, if the company is a resident of both the United States and either the United Kingdom or Australia, it is able, in effect, to use its losses to offset the income of commonly owned corporate residents in the two countries. (The committee is aware of the ability to share losses in this way only in the case of Australia and the United Kingdom; this ability may occur in other cases as well.) In general, neither of these countries taxes the active business income of foreign corporations that operate solely abroad.

Corporate groups attempt to isolate expenses in dual resident companies so that, viewed in isolation, the dual resident company is losing money for tax purposes. This isolation of expenses allows, in effect, the consolidation of tax results of one money-losing dual resident corporation with two profitable companies, one in each of two countries. This use of one deduction by two different corporate groups is sometimes referred to as "double dipping." The profitable companies report their income to only one country.

According to the Committee, "[l]osses that a corporation uses to offset foreign tax on income that the United States does not subject to tax should not also be used to reduce any other corporation's U.S. tax." The Committee thus found it offensive for a single tax occur-

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35 Pub. L. No. 99-514 § 1249(a), 100 Stat. 2085, 2584. The ultimate action is set forth clearly in § 1503(d)(1): "The dual consolidated loss for any taxable year of any corporation shall not be allowed to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable year." The term "dual consolidated loss" means "any net operating loss of a domestic corporation which is subject to an income tax of a foreign country on its income without regard to whether such income is from sources in or outside of such foreign country, or is subject to such a tax on a residence basis."

37 Id.
rence (a loss), normally and properly deductible on a U.S. tax return, to give rise as well to a deduction under foreign law that was usable against income not subject to U.S. taxation. The ex cathedra tone of the pronouncement implies that its rationale is obvious. Is it?

The Finance Committee was motivated by a concern that "double dipping" could give an advantage to potential foreign acquirers of U.S. businesses. The advantage presumably works against potential domestic acquirers of such businesses, who do not have income in two taxing jurisdictions and thus cannot take advantage of the "double dip." As the Committee observed, "denial of double dipping to foreign-owned businesses that operate in the United States is necessary to end U.S. discrimination against U.S.-owned businesses that operate in the United States."38 The concern was that a DRC might allow foreign persons to make investments in the United States with a negative marginal (worldwide) tax rate. "The committee believes that the dual resident company device creates an undue incentive for U.K. corporations (and Australian corporations) to acquire U.S. corporations and otherwise to gain an advantage in competing in the U.S. economy against U.S. corporations."39

In response to the argument that "the United States should not pay attention to the tax treatment that foreign countries apply to U.S. corporations," the Finance Committee replied that "[t]he United States frequently takes foreign taxation into account." It noted that "in particular, in allowing a foreign tax credit, the United States carefully considers the tax system of foreign countries."40

The Committee accordingly proposed that losses of a foreign-owned DRC not be allowed to reduce the income of other U.S. members of the affiliated group. Obviously, the focus here was inbound investment, and the potential for competition between foreign investors and similarly situated U.S. persons. In fact, competition concerns represent a common thread of U.S. tax policy affecting U.S. investment by foreign persons. Such concerns undeniably have informed the tax regime applicable to foreign persons engaged in a U.S. trade or business or deemed to be so engaged.41

In conference, however, the statutory remedy for DRCs (changed in various technical respects) was broadened to reach outbound investment—companies ultimately owed by U.S. persons. The conferees made this change because they believed it was fair: "[t]he conferees are not aware of a case where the use of one company's

38 Id.
39 Id. at 421.
40 Id.
41 See IRC §§ 864, 884, 897.
determination by two other companies in two tax jurisdictions makes sense as a matter of tax policy. In addition, the conferees took note of the arguments that the Senate provision "discriminated against foreign-owned U.S. corporations." The statute as amended by the conference would restrict the use of losses in the United States when those losses are "shared with foreign corporations whose earnings will be subject to U.S. tax (which are typically U.S.-controlled) and not only to losses shared with foreign corporations whose earnings are never subject to U.S. tax (which are typically foreign-controlled)."

The 1986 legislative materials presumably make the best case that Congress (or staff) could imagine against DRCs, the archetype of international tax arbitrage. But at the end of the day, what was that case? On a political level, the intent of Congress was plain. It had received complaints that foreign persons enjoyed an unfair advantage because some of those persons, from the United Kingdom and Australia, could use DRCs to gain tax benefits for a single loss in more than one taxing jurisdiction. These benefits gave those persons an economic advantage in bidding for U.S. businesses. To this concern the conferees added a "fairness" or "nondiscrimination" concern that resulted in extension of the provision to U.S. controlled dual residents.

Lost in the debate were two questions that seemed reasonably important at the time and that have grown considerably in importance in the ensuing 12 years: (1) Are DRCs relevantly different from other techniques for taking advantage of differing tax rules in different countries? (2) What tax policy justifies the elimination of otherwise available U.S. tax benefits for the sole reason that the person claiming such benefits (or an economically related person) also enjoys benefits, tax or otherwise, in another country?

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43 Id. Most tax treaties contain prohibitions against discrimination in tax matters. The U.S. Model Income Tax Convention, Sept. 20, 1996, art. 24(4), 1 Tax Treaties (CCH) ¶ 214, provides that "[e]nterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected." The nondiscrimination argument would be that a limitation on deductibility of losses of a foreign-owned DRC is discrimination in the absence of any such limitation on losses of U.S.-owned dual residents. Arguably, however, the fact that income of U.S.-owned foreign affiliates is subject to U.S. tax when repatriated to the United States establishes a "dissimilarity" between the two situations. See text accompanying notes 49-53.
44 Conference Report, note 42, at II-657.
45 It also could be that esthetics played a role. One staff member observed to the author at the time that the dual resident technique belonged in the "hall of fame of tax abuse."
These are questions for which the drafters of § 1503(d) had little patience. With the perspective provided by Notice 98-11 and other celebrated instances of international tax arbitrage, a fresh attempt at answers seems worth the effort.

A. DRCs Are Different Because . . .

The DRC represents a clear-cut example of deliberate, direct, transactional arbitrage. A duplication of tax benefits is obtained through the intentional use of a corporation organized in the United States and therefore resident in the United States for U.S. tax purposes but managed and controlled in another country and therefore resident in that country under its tax law. Through borrowings or otherwise, the corporation is placed in a loss position and the loss is claimed, through the consolidation and grouping rules of each country, as an offset to positive income in each country. There is nothing diffuse, indirect, or accidental about this planning, which generally is undertaken for a specific purpose such as the acquisition of a U.S. business. From the U.S. point of view, the planning produces a U.S. deduction that may be used to reduce the tax on purely U.S. income of related corporations, while also producing a parallel deduction in the United Kingdom (or Australia).

Legislation targeting such planning for the sake of competitiveness is, however, unusual. Although competition with U.S. persons is a routine consideration in the formulation of U.S. tax policy with respect to foreign persons, the focus is normally on the effect of U.S. rules. That is, we ask whether the manner in which we assert taxing jurisdiction over foreign persons provides an undue advantage or is unjustifiably injurious by comparison with the rules we apply to U.S. persons. We generally do not inquire whether the foreign person is receiving a benefit, tax or otherwise, outside the United States by virtue of, or simultaneously with, the structure or actions that that person has implemented in the United States.

One reason we generally do not engage in that inquiry is the problem of drawing lines. It is difficult to say which benefits in foreign countries are relevant. Advertently or not, the United Kingdom or Australia could adopt rules having indirectly the same effect as the grouping rules that allow losses of a DRC to be used against the taxable income of related entities. They could provide a tax credit or cash subsidy to the group for investments by a group company in a foreign country, or in the United States specifically, or in a particular industry. Or, by not imposing tax on the income of controlled foreign affiliates,

46 See, e.g., Notice 98-5, note 32.
they could facilitate a similar result by allowing their resident compa-
nies to borrow and deduct interest on the borrowing, use the bor-
rowed funds to create an affiliate in a tax haven, and have that affiliate 
finance a U.S. acquisition with a loan giving rise to deductible interest 
in the United States. The effect in each case would be a dual benefit 
for the group, though not necessarily a parallel and direct benefit in 
the sense of a benefit triggered in the same terms, and at the same 
time, by a single occurrence recognized in both jurisdictions (such as 
accrual of interest expense). In other words, there may not be any 
obvious and direct “correspondence” between the foreign benefit and 
the U.S. benefit. For all we know, however, at any given point in time, 
dual benefits of the nature described exist in the tax systems of the 
United Kingdom or Australia, or other nations whose tax systems 
come into play once the debate proceeds beyond the DRC to other 
instances of arbitrage.

If competition is the crucial consideration but analysis proceeds be-
yond specific transactions, the concept of “dual benefits” is even more 
slippery. If Japan was to reduce its corporate tax rate to 20%, surely a 
Japanese automobile manufacturer who sells vehicles to a U.S. subsidi-
ary would receive an important tax benefit. Furthermore, the benefit 
received in Japan undoubtedly would be of value to the entire eco-
nomic enterprise, and might be enjoyed, albeit indirectly, across entity 
lines within the corporate group. (The loss generated by the DRC, 
after all, produces benefits not for the dual resident itself but for other 
members of the group.) Surely it would become easier for the group, 
through the U.S. affiliate, to do business and compete in the United 
States. Alternatively, there may be a foreign benefit in practice that is 
not derived from legal rules. Indulgent tax administration in the 
country of residence is probably beneficial, as a raw economic matter, 
to persons having such residence. Conceivably, the resulting eco-
nomic benefits may make it easier for those persons to engage in com-
petition with U.S. persons on U.S. soil.

B. The Problem Transcends Line Drawing

It is not a full or satisfactory response to the types of cases identi-
ified above that it may be relatively simple to identify the “duplica-
tion” of benefits in the case of a DRC. That response does not 
explain why the identified cases are different in substance from DRCs, 
or why, on policy grounds, any of these situations should result in a 
reduction or elimination of U.S. tax benefits—why the United States 
should even consider altering the available U.S. interest deduction be-
cause Japan has lowered its corporate tax rate or Canada (for ex-
ample) has adopted particularly beneficial rules for foreign investment by
Canadian insurance companies. These cases merely involve taxpayers taking advantage of the national tax laws of different nations. It seems appropriate to link the denial of U.S. tax benefits to benefits available under the laws of other countries only if we conclude that the United States has a policy interest that tax be imposed by those countries at some minimum level on income not subject to U.S. taxation. What is that policy interest? The direct correspondence—parallelism—of benefits in some cases but not others may come into play as a way of easing administration only after a reason for concern in the most administrable of situations has been identified.

The DRC is surely an administrable case (although the absence of an intelligible purpose for § 1503(d) has made the development of interpretive regulations an exceptionally complex task). And it may be noted that the combination of benefits was unforeseen—apparently not intended—by any single country, and the taxpayer would not have engaged in the planning but for the availability of duplicate tax benefits. In all probability, neither the United Kingdom nor Australia adopted residence and grouping rules with the intention that taxpayers take advantage of the juxtaposition of these rules with those of the United States to obtain benefits in both countries. It doubtless can be stipulated, moreover, that most taxpayers would not have engaged in the formation and use of DRCs if benefits were limited to one country. Still, from the standpoint of any one country, including the United States, it is not clear what, if anything, flows from these observations. The taxpayer obviously has engaged in tax planning. But that, by itself, is not normally cause for a loss of tax benefits, as long as the result is a real transaction in which substance and form coincide. As noted above, country rules regarding taxation inevitably will differ in many respects, and the well-advised taxpayer will pay attention to, and seek to derive advantage from, the differences.\(^47\) It is hard to see why such fully anticipated behavior of the taxpayer should be the target of legislative pique in any country.

If there is any justification for this pique, it must lie in the area of competitiveness—specifically, the relationship between the combination of benefits achieved through arbitrage and the solitary (U.S.) benefit available to the U.S. person who is unable to put itself in a position to take advantage of arbitrage possibilities. This is the rationale that the Senate Finance Committee invoked in 1986, and perhaps this is the policy underpinning of the “international tax system” to which the Committee referred.\(^48\) But consider the point in stark terms: It implies that the United States would have an interest in the

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\(^{47}\) See text accompanying notes 5-15.

\(^{48}\) See text accompanying note 1.
level of French tax on French income of a French resident assuming that the French resident was also, or became, a U.S. taxpayer, or, perhaps, invested in a U.S. taxpayer. Line-drawing concerns might dictate that the policy not be pursued in all conceivable situations, but line-drawing concerns are conceptually independent of the policy itself.

An attempt to "level the playing field" by mandating that foreign persons directly or indirectly entering the U.S. tax system must pay tax at some acceptable level on non-U.S. income is inconsistent with the practical nature of taxation. Certainly there are better and worse tax systems. But the overriding justification of taxation is that it represents a way for government to fund itself on a periodic basis. There is no time for perfection, only for improvement. And there is no clear reason to seek through the tax system an ideal of egalitarianism not pursued in other aspects of national life. In setting public utility rates, we do not take into account the charge for similar services in Germany, even with respect to persons who also happen to be U.S. customers. Why, then, in establishing U.S. tax rules for those persons should we be concerned about the rate of tax they are called upon to pay on rental income in Berlin?

We do not seek to advance any such interest in a purely domestic context. U.S. persons derive varying benefits under various state and city tax laws; yet there is no equalization attempted at the federal level. Although taxation is generally higher among foreign taxing jurisdictions than at the state and local level, the difference in taxation between, say, California and Texas is not insubstantial. Yet, there has never been any hint of attempting to achieve equality of competitive opportunity by limiting or withholding otherwise available federal benefits to reflect benefits made available by the states and municipalities.

Furthermore, competitiveness as an explanation of policy clearly applies only to the inbound situation, when foreign persons enter into U.S. taxing jurisdiction. The extension of that policy to U.S. persons is, independently, questionable. Congress based that extension on the notion that the foreign-owned U.S. corporation denied a deduction for losses incurred by a DRC stands in the same position as a U.S.-owned U.S. corporation claiming a similar deduction. In both cases, the DRC scheme gives rise to a deduction under the rules of a foreign country simultaneously with the U.S. deduction. But are the two cases really similar? The United States has never viewed U.S. persons taxable on a net basis on worldwide income as similar to foreign persons subject to only limited U.S. taxing jurisdiction. For this reason, treaty nondiscrimination rules do not operate with respect to foreign
residents, as a general matter. The only exceptions are with respect to the deductibility of payments to such persons by U.S. taxpayers, the treatment of U.S. permanent establishments of such persons, and the taxation of U.S. corporations owned by such persons. These limited rules should not force the United States, once it determines to deny U.S. tax benefits to foreign-owned taxpayers enjoying foreign benefits on foreign income or activities, to apply a similar rule to U.S.-owned taxpayers enjoying comparable foreign benefits but subject to an entirely different U.S. tax regime. The fact that the income of foreign entities under U.S. ownership is ultimately subject to U.S. taxation is a better response to charges of discrimination than the United States has offered in other contexts, and it should be sufficient to differentiate these entities from foreign-owned foreign entities and, therefore, place them beyond the purview of treaty nondiscrimination rules.

The counter-argument would have to be that deferral is a misnomer, that if the income of foreign entities owned by U.S. persons escapes current taxation under U.S. anti-abuse rules, it is effectively exempt from U.S. taxation. It is hard to believe that anyone in a responsible tax policy position in the United States would be willing to advance that point of view.

For these reasons, competitiveness and nondiscrimination represent shaky foundations for the assault on DRCs, much less for a more general attack on international tax arbitrage. And deliberate international duplication of tax benefits not foreseen by any one country plainly extends beyond DRCs. The main point at issue, in the case of such companies, is the rule for determining an entity's residence: The United States looks to place of incorporation, while the United Kingdom and Australia look to place of management and control. If there is any cause for objection here, it should apply as well to double and

49 See, e.g., OECD, Model Tax Convention on Income and Capital (July 23, 1992), 1 Tax Treaties (CCH) ¶ 191.

50 See, e.g., id., ¶¶ 3-5.

51 All countries routinely “discriminate” against foreign persons in tax matters, but the United States has been especially sensitive to charges of discrimination. When plainly discriminating against foreign persons, it has allowed them to elect to be taxed as domestic persons, IRC § 897(i), justified the discrimination by (dubious) comparison to tax-exempt domestic persons, IRC § 163(j), and talked itself into the conclusion that discrimination did not exist, IRC § 884(f)(1)(B), Notice 89-90, 1989-2 C.B. 394; Treas. Reg. § 1.882-4; Tech. Adv. Mem. 199941007.

52 The nondiscrimination argument does not pertain to the DRC itself, which is entitled to its U.S. deduction under § 1503(d), irrespective of ownership. The denial effected by § 1503(d) only operates with respect to a related U.S. corporation claiming use of the deduction under the consolidated return rules.

triple dip leases, where the focus is on defining ownership, and to
cases where an instrument treated as stock in one country constitutes
debt in another. As noted previously, the field of arbitrage and arbi-
trage possibilities not anticipated by any country is large indeed.

Moreover, if arbitrage is objectionable from the standpoint of tax
policy, the international application of the check-the-box regime also
must be questioned. Arbitrage stems from differences in the way
countries approach the myriad elements that comprise a tax system.
Whenever any country adopts a rule that is either difficult to replicate
or apply (for example, the U.S. rules for distinguishing debt from eq-
uit) or markedly out of step with what other countries do or are
likely to do, a breeding ground for arbitrage is created. Whatever
the justification for check-the-box as a matter of U.S. tax policy—a
justification primarily based on administrability concerns—the
regime is clearly idiosyncratic as an international matter and thus lends
itself to the same type of planning to take advantage of country differ-
ences against which the DRC legislation was directed. Furthermore,
because the check-the-box regime is so easy for taxpayers to use, the
invitation to arbitrage is especially compelling. Thus, when the
United States determined that the status of a business entity as a cor-
poration or partnership would be determined by the taxpayer's unilat-
eral choice, and not by objectively verifiable entity attributes, it was
contributing directly to the expansion of arbitrage opportunities. Yet,
Treasury adopted check-the-box, and Congress has not voiced any se-
rious criticism.

54 Reg. §§ 301.7701-2, -3.
55 Consider, for example, the rule set forth in § 860H(c)(1), as enacted in recent legisla-
tion pertaining to financial asset securitization investment trusts: "[A] regular interest in a
PASIT, if not otherwise a debt instrument, shall be treated as a debt instrument." IRC
§ 860H(c)(1); Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1621(a),
110 Stat. 1755, 1858-59. A clearer invitation to international arbitrage would be difficult to
imagine.
56 See generally Notice 95-14, 1995-1 C.B. 297 (containing the preamble to proposed
regulations).
57 As a test of how much the check-the-box rules stand at variance with § 1503(d), con-
sider the response of U.S. tax policymakers if it were suggested that entity residence, in
addition to classification, might be determined by making an election on an appropriate
form.
58 See Staff of Joint Comm. on Tax'n, Review of Selected Entity Classification and Part-
nership Tax Issues (Apr. 8, 1997), 97 TNI 69-22, available in LEXIS, TNI File. Check-the-
box is only the most significant example of tax policy pronouncements that cannot be rec-
conciled with general hostility to tax arbitrage. The Service has been cheerfully supportive
of double dip leases notwithstanding the compelling similarity of such arrangements to
dual resident companies and the Tax Court's decision (apparently widely disregarded) in
see Field Service Advice 199934009 (1999), where the Service, relying in significant part on
Coleman, suggests that arbitrage calls into question the "substance" of a transaction or
Of course, Congress is not obliged to legislate with respect to all aspects of a potential target just because it finds one repugnant. The DRC scheme was brought to congressional attention in 1986, and the legislators reacted to the scheme as it was presented to them. Arguably, they were not required to cast around for other comparable situations. It seems, however, that a minimum level of rational behavior is desirable even in tax matters—that some explicable line should exist between circumstances singled out for legislative action and those left for another day, particularly when the same ends may be served by both sets of circumstances. This is not an instance of the state trooper allowing one speeding vehicle to pass without challenge while arresting the next one. The trooper here has stopped one vehicle while actively encouraging other speeding vehicles to go faster.

It is possible, for all the foregoing reasons, to be skeptical regarding the need to address the subject of international tax arbitrage as a general matter. The task of identifying elements in another country’s tax system that are a sufficient source of concern for otherwise available U.S. tax benefits to be limited or denied is difficult, time-consuming, and endless: It is hard to distinguish one form of arbitrage from another, to distinguish arbitrage in general from other tax minimization strategies, to distinguish tax benefits from other benefits that may be enjoyed outside the United States by persons related to the U.S. taxpayer. Moreover, the reasons for concern are murky; it seems justifiable only on the basis of a mysterious “international tax system” in which U.S. benefits are withdrawn, on general competitiveness and nondiscrimination grounds, by reason of benefits enjoyed in other jurisdictions with respect to tax (or other) rules having nothing to do with the United States. The attributes of deliberateness, parallelism, elegance, and lack of foreseeability by any one country do not add up to a tax policy.

The objection to addressing international tax arbitrage is not merely limited to the difficulty of doing so in a rational and feasible way. The broader objection is that there does not appear to be any clear reason why U.S. tax policy should take account of the fact that the taxpayer or a related party enjoys benefits under the tax laws of another country with respect to income or activities not subject to U.S. taxation. The treatment of that income or those activities is not obviously our business, and there is no clear reason why we should make it our business—any more than the rules of that other country applicable to its

characterization. This approach is not likely to be very useful where countries take a different view of what the tax-controlling substance is.

59 Thus, the legislation is directed only at losses, because losses were on the minds of the lobbyists that prodded Congress to act. It is axiomatic in international tax matters that credits and losses behave in much the same fashion.
own citizens and residents on its own soil with respect to anticompetitive behavior, corrupt practices, or the price of water.

Contrary to the 1986 Finance Committee Report, the foreign tax credit is a different matter. The credit reflects a U.S. commitment to reduce or eliminate international double taxation with a goal of facilitating (or removing obstacles to) U.S. enterprise outside U.S. borders. The commitment is limited to income taxes and taxes in lieu of income taxes, and some attempt to categorize foreign imposts in light of these standards is therefore necessary. The credit requires a narrow inquiry with a specific, easily defined (if not always easily applied) purpose. The foreign system is taken as we find it and categorized in U.S. terms. Arbitrage is different. The search here is for a benefit enjoyed outside the United States. Broadened in a rational way, the DRC approach would link denial of U.S. benefits to the existence of elements in a foreign country's tax or legal system that allow for independent benefits of a specified nature. Whether those elements would be narrow and limited, and corresponding in some sense to otherwise available U.S. benefits, or broader and more diverse, is itself a policy choice of major proportions. In either event, the inquiry would be into the legal operation and practical effect of the foreign system with respect to income or activities not subject to U.S. tax jurisdiction. There is common ground between such an inquiry and the one envisioned by the foreign tax credit rules only insofar as they both involve scrutiny of a foreign tax system.

One lesson from the evolution of the Code is that logic can be overvalued. It was, after all, rigorous logic that produced the foreign tax credit limitation of §§ 904(b) and (d). Nevertheless, it is perplexing to have laws in which DRCs come in for strict scrutiny while Treasury and the Service actively facilitate other transactions in which arbitrage benefits may be claimed. As matters stand today, U.S. tax laws attack DRCs, tolerate double dip leases, encourage arbitrage with respect to entities, and provide that even stock is to be treated in specified circumstances as debt. The aberrant element here seems to be § 1503(d), a statute that the legislative history does little to justify. The congressional references to “competition” from foreign owned

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60 See text accompanying note 40.

61 The “dual capacity taxpayer” rules of Reg. § 1.901-2A are an exception, adopted largely on political grounds, to the general statement in text. They envision a U.S. reformulation of the foreign tax system. To similar effect is the treatment of the Italian regional tax on productive activities in the new income tax convention between the United States and Italy. Convention for the Avoidance of Double Taxation, Aug. 25, 1999, U.S.-It., art. 23, 2 Tax Treaties (CCH) ¶ 4801.23.

62 IRC § 860H(c) (stating that “regular interests” in a FASIT will be treated as debt irrespective of their form, which may be stock for other purposes).
companies are not satisfying, and the application of the legislation to U.S. controlled companies in order to avoid "discrimination" is unpersuasive. In the absence of some compelling (but heretofore unexpressed) policy reason favoring § 1503(d) and similar statutes aimed at schemes similar to DRCs, it is hard to see why international tax arbitrage should be a source of general U.S. tax policy concern.

IV. Ah, Yes! But Is There a Specific Problem?

There is a demonstrable U.S. interest in international tax arbitrage, but it is limited in scope. A specific, identifiable U.S. tax policy issue deserving of attention exists because, in various sections of the Code, the United States has surrendered to the temptation of using foreign taxation as a means of pursuing U.S. tax policy concerns. This technique seems questionable because it places the United States on both sides of the basic question whether any particular level of foreign tax should be encouraged. As noted below, there are various economic reasons for the United States to adopt a hands-off position on whether and when foreign countries should tax, and at what level.

One example of the cited technique is § 865 under which the source of certain income from personal property sales turns in part on the existence of a minimum foreign tax. Another example, more extensive in application, is the series of provisions that look to the actual or presumed application of foreign tax rules as a means of implementing subpart F. In each case, foreign taxation is regarded as evidence of the bona fide of a foreign presence. It allows the United States to conclude that the person or entity in question has justified its situation abroad, which situation produces U.S. benefits in the nature of deferral and foreign sourcing (nontaxation) of certain income. In such circumstances we have deliberately made foreign taxation into a U.S. tax issue.

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63 IRC §§ 865(e)(1)(B), 865(g)(2).
64 E.g., IRC § 954(b)(4).
66 The point is different from the one underlying the recently issued § 894 regulations and enactment shortly thereafter of a statutory amendment to § 894. Reg. § 1.894-IT; IRC § 894(c). These authorities would have U.S. benefits under tax treaties turn upon the tax treatment applied by the treaty partner. This, of course, represents an example of arbitrage in the broader sense defined in note 25. Moreover, the question here is whether entitlement to treaty benefits should be determined under the rules of the United States or those of the treaty partner. The bilateral nature of this question—what was the intention of the treaty negotiations and the resulting international conventions—distinguishes it clearly from the issues discussed in text.
In light of the explosion of criticism caused by Notice 98-11\textsuperscript{67} and only partially put to rest by Notice 98-35 and subsequent events,\textsuperscript{68} the subject of deferral is especially pressing. This question obviously involves U.S.-owned foreign entities, the outbound situation in which the rationale for anti-arbitrage sentiment seems especially weak. Treasury and the Service have been severely criticized for attempting in Notice 98-11 to backstop the tax systems of other countries, thereby causing U.S. enterprises to pay a higher level of foreign tax than they otherwise would.\textsuperscript{69} Some view this as a sharp about-face of U.S. policy, making little sense for the U.S. fisc.\textsuperscript{70}

As a general matter, it is hard to see why it is a function of U.S. tax authorities to ensure that foreign governments collect any particular amount of tax, either generally or from U.S. companies and their affiliates. This is not a way to keep U.S. foreign tax credits to a minimum. It is not a way to encourage the foreign success of U.S. enterprise. It has corrupting effects on the "compulsory payment" rules of U.S. foreign tax credit theology.\textsuperscript{71} Sometimes, however, and this is the nub of the problem, foreign taxation has been used as a factor in U.S. taxation, as a way of distinguishing those enterprises that have a legitimate purpose for establishing foreign affiliates from those that are simply attempting to reduce the U.S. tax burden.

The 1962 legislation that produced subpart F\textsuperscript{72} resulted from a compromise between a Kennedy Administration proposal that deferral be eliminated and the fierce defense of the U.S. multinational community that forgoing current taxation of the income of a controlled foreign corporation (CFC) was needed in order to maintain international competitiveness of U.S. enterprise.\textsuperscript{73} The compromise that has rested at the core of the statute ever since is that deferral is acceptable for a CFC if there is a demonstrated business need for operating abroad in foreign corporation solution.\textsuperscript{74} Local purchase, sales, and services ac-

\textsuperscript{67} Notice 98-11, note 34.
\textsuperscript{69} See, e.g., Paul Cherecwich, Jr., TEI Calls Hybrid Arrangements Notice "Poor Tax Policy," 98 TNT 54-34, Mar. 20, 1998, available in LEXIS, TNT File.
\textsuperscript{70} Id.
\textsuperscript{71} Reg. §§ 1.901-2(a)(2), -2(e)(5).
\textsuperscript{74} The rationale for the compromise can be debated. Some view subpart F as resting on considerations of capital export neutrality, the desire to remove tax considerations from deliberations of a U.S. person determining whether to situate an investment in the United States or abroad. Notice 98-11, note 34. Others maintain that subpart F is really aimed primarily at protecting the U.S. tax base. National Foreign Trade Council, note 73, at 2-21. The two rationales are subtly different, but the essence of the compromise does not depend
tivities in the foreign country of incorporation satisfy this requirement in and of themselves. So do manufacturing activities. Other active business endeavors in the nature of services or licensing also may justify foreign incorporation as long as certain additional conditions are met: in the case of services, that the foreign corporation is not receiving substantial assistance from related persons; in the case of licensing, that an active business enterprise is being carried on.\footnote{Reg. §§ 1.954-4(b), -2(d).}

For many other activities and functions, those that generate passive income and those that are inherently mobile and thus presumably could have occurred in the United States, there is generally no deferral unless it can be shown that foreign taxes at a sufficient level apply to the resulting income. This is an obvious use of foreign taxation to meet U.S. tax policy concerns. It is thought that if the foreign affiliate is paying tax at a high rate, the affiliate must be serving a genuine nontax purpose. Deferral, in these circumstances, applies.

Passive income also qualifies for deferral if it is earned by a CFC incorporated under the laws of the same country as the payor of the income, and if the payment does not (as a U.S. matter) reduce income that otherwise would be disqualified for deferral and taxable currently in the United States.\footnote{IRC § 954(c)(3).} The assumptions underlying this rule seem to be that residence of the foreign entity is determined for foreign purposes according to place of incorporation, that is, in the same way as in the United States, and that it does not matter if the foreign country collects its residence-basis tax from two entities rather than one. The United States says, in effect, that operating through two entities should not diminish or eliminate an opportunity for deferral that a single entity otherwise would have.

Another use of foreign taxation in the implementation of subpart F relates to the foreign base company sales rules. If a CFC operates through a branch or similar establishment in a country other than the country of incorporation, and the effect is as if the branch were a wholly owned subsidiary of the CFC, the branch will be considered a separate subsidiary corporation for purposes of those rules.\footnote{IRC § 954(d)(2).} The statutorily described effect is found if taxes on the branch are below a designated percentage of the taxes that would have applied in the country of incorporation.\footnote{Reg. § 1.954-3(b)(1)(i)(b). There has been considerable debate over the meaning of the term “branch or similar establishment.” See Ashland Oil, Inc. v. Commissioner, 95 T.C. 348 (1990); Vetco, Inc. v. Commissioner, 95 T.C. 579 (1990); Rev. Rul. 97-48, 1997-2 Imaged with the Permission of N.Y.U. Tax Law Review}
lations) looks to the level of foreign tax to determine whether the "branch rule," and therefore potential current U.S. taxation, will apply.\footnote{Qualification for deferral may yet be achieved on the basis of the foreign tax level, even if there is a disparity in tax rates between the country of the branch and the country of incorporation. IRC § 954 (b)(4).}

International tax arbitrage is relevant to this statutory and regulatory scheme because it can allow taxpayers to reduce the foreign tax burden in the country where a CFC is incorporated without disturbing qualification for deferral under other statutory justifications for a foreign presence. To the extent U.S. law depends directly on the level of foreign taxation, the reduction accomplished by arbitrage automatically is taken into account by the U.S. rules. The level of foreign taxation, however, is only one of the statutory justifications for a foreign affiliate, and the effects of arbitrage are not necessarily inconsistent with the others. As Notice 98-11 observes, a payment of interest from a CFC to an entity that the foreign country of incorporation regards as separate (and resident in another country) but the United States treats as a branch of the payor and thus nonexistent for tax purposes may reduce tax in the country of incorporation and yet not be subject to tax in the United States.\footnote{Notice 98-11, note 34.}

This circumstance arguably evokes the same kind of policy concerns that led Congress in 1962 to provide the branch rule for foreign base company sales income.\footnote{See Revenue Act of 1962, Pub. L. No. 87-834, § 12(a), 76 Stat. 960, 1009-13 (adding IRC § 954).} Alternatively, a payment of interest or dividends may be viewed by the country of incorporation as a payment to a third country and yet be regarded by the United States as a same country payment if the United States sees the recipient as a branch of a second corporation incorporated in the same country as the payor.

The branch rule was a late addition to the original subpart F statute and limited in scope. Moreover, the statute was enacted long before the current fashion of legislating rough drafts and leaving the heavy technical lifting to Treasury and Service regulation writers. There is only limited scope for policy-oriented embroidery here.\footnote{It might be argued that Treasury has exceeded what scope there is in applying the branch rule in the case of a "manufacturing branch" as opposed to the "sales branch" clearly described in the statute.} Thus, the effort to extend the branch rule from its origins in the universe of foreign base company sales income to deemed payments of foreign personal holding company income appears quixotic under current law.

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C.B. 89. From a policy viewpoint, there probably should be less focus on Webster's and more on the question whether there has been a meaningful reduction of residence country tax.
The deeper question, of course, is whether the United States should be concerned, and this, in turn, depends upon how one is to view the 1962 compromise today, either as a historical matter or as a topic of current tax policy. Insofar as the historical question is concerned, one approach is to probe the U.S. attitude toward the subsequent use of income that qualifies, when earned, for deferral.

Congress gave an answer of sorts to this question when it first enacted and then repealed § 956A, relating to excess passive assets. It thus conveyed the message that the 1962 compromise favored deferral, not its opposite, that current taxation of the income of CFCs was the exception to a general rule, and that income once deferred may remain deferred indefinitely. On this view, subpart F expresses concern not about any long-term advantage to the investment of capital abroad in foreign corporate solution but, much less comprehensively, about whether particular items of income might not just as well have been earned by a U.S. person. If this is a correct interpretation of subpart F, the United States has no general policy interest in any particular level of foreign tax, but only in the question whether an acceptable justification for deferral (which can derive from the level of foreign tax but need not) has been established. In fact, it is probably in the national interest for the foreign tax burden on affiliates of U.S. companies that are legitimately incorporated and earning income abroad to be lower rather than higher. If a CFC engaged in manufacturing activities pays “interest” to what Notice 98-11 refers to as a “hybrid branch,” an entity recognized in the foreign country of incorporation but whose existence is denied by the United States, the net effect is to reduce the foreign tax rate on manufacturing activities, from a U.S. viewpoint. Since manufacturing qualifies for deferral per se, and since both the rate of foreign tax and the use of the deferred income are irrelevant to that qualification, there is arguably no U.S. tax policy interest here.

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84 Notice 98-11, note 34.
85 In this connection, it is worth underscoring that the existing branch rule does not operate merely on the basis of a low foreign tax rate. It also must be shown that when the branch is viewed as a separate entity, either the activities of the branch or those of the remainder of the corporation give rise to foreign base company sales income. Reg. § 1.954-3(b)(1)(i)(a). Thus, a CFC that manufactures a product and uses a branch in a second foreign country as a contract manufacturer of a component qualifies for deferral irrespective of the level of tax in either country. For general discussions of the branch rule, see Leonard R. Olsen, Jr., Affirmative Use of the Branch Rule, 1 Int’l Tax J. 172 (1975); Leonard R. Olsen, Jr., Working With the Branch Rule of Section 954(d)(2), 27 Tax Law. 105 (1973).
The 1962 compromise seems to have regarded manufacturing income as qualifying for deferral not because of any expressed assumption that manufacturing would be undertaken only in high-tax foreign countries (there is no hint of such an assumption in the statute or legislative history) but because an activity as solid and "real" as manufacturing was less mobile than many other activities, required a capital investment, and arguably could be viewed as necessitating (or at least explaining) a foreign incorporated presence. There are some questionable assumptions in this chain of reasoning, but it is not clear that any of them turned, in 1962, on the effective rate of foreign tax. The thought was that a taxpayer prepared to engage abroad in something as substantial as manufacturing is entitled to do so through a foreign entity.

If this view is accepted today, there is no reason for the United States to object to any legitimate means of reducing the foreign tax burden on manufacturing activities. True, the hybrid branch removes income, on a tax-deductible basis, from the country of incorporation, but if the United States does not care in the first place how high the foreign tax is and has chosen not to concern itself with the disposition of deferred income, except insofar as that income generates further income not qualifying in its own right for deferral (or is repatriated to the United States and becomes subject to tax as an investment in U.S. property), it is difficult to articulate the U.S. objection to the hybrid branch. The technique potentially would allow all foreign manufacturing to bear a low rate of foreign tax, but is that clearly an undesirable result? The lower effective rate of tax could draw some manufacturing activities, the most mobile, from within the United States, but the 1962 compromise envisioned (or at least tolerated) that result in the case of manufacturing in low-tax foreign jurisdictions and the fact that hybrid branches are capable of converting all jurisdictions into low-tax jurisdictions does not clearly undermine what is, in effect, one of the bedrock aspects of the 1962 compromise. On this view, the hybrid branch merely represents a creative use of the tax laws of the foreign country of incorporation.

Nor is the analysis any different if some or all of the income of the CFC is subject to current U.S. taxation under subpart F. The hybrid branch still has the effect of reducing the effective foreign tax rate. Either this results in a concomitant loss of the justification for deferral (because the foreign tax is no longer sufficiently high to furnish such a justification) or a lesser foreign tax credit on income taxable under § 951. In either event, it is difficult to identify a U.S. tax policy concern.
It is possible that the foreign country of incorporation could view the hybrid branch technique as an aggressive U.S. scheme for depleting its tax base, and this could lead to ill feelings or even retaliation. But why should these consequences ensue? The taxpayer is merely claiming a legitimate interest deduction under the laws of that country. Moreover, the foreign country is not powerless in these circumstances. Engaging in the same analysis the United States employed in regard to DRCs, it could choose, if it so desired, to deny interest deductions because of the U.S. treatment of hybrid branches. This would be a fairly extreme position, however, since the effect of the hybrid branch is to achieve an interest deduction in the foreign country while the United States merely ignores what that country sees as the corresponding interest income. It would be strange (but perhaps no stranger than the U.S. analysis with respect to DRCs) for the country of incorporation to limit or eliminate its interest deduction just because the anti-abuse rule of subpart F does not apply to the income it perceives, since there are many countries that do not have a regime like subpart F at all. The country of incorporation may not grasp all the subtleties of the U.S. check-the-box rules, but it is hardly clear why it should wage tax war over the issue as it appears in Notice 98-11.86

The second situation involved in Notice 98-11, where the taxpayer invokes the “same country” justification for deferral with respect to interest or dividend income that crosses from one entity to another, is a different matter. This is not a case involving a reduction in foreign tax without a corresponding U.S. income inclusion on the ground that the United States sees no income under its rules. Rather, U.S. rules and those of the country where the payor is incorporated both see income, but they differ on the question of whose income it is. The United States views the hybrid branch as part of a corporation incorporated under the laws of the same foreign country as the payor. That country perceives the recipient as a third-country entity. The third country either does not tax or taxes at a low rate. Presumably, if interest is involved, the income of the payor qualifies for deferral as income from manufacturing or on some other basis since the same country justification for deferring tax on interest income does not apply if the interest reduces subpart F income.

In this situation, the hybrid branch is used to undermine the “same country” justification for deferral because it produces a same country

86 Notice 98-11, note 34. On the other hand, that country is not without power to limit deductions, whether for interest generally, for interest payable to affiliates (domestic or foreign), or for cross-border interest. Cf. IRC § 163(j) (imposing a limitation on the deduction of interest in cases involving “earnings stripping”).
payment for U.S. purposes but not for those of the foreign country of incorporation. There are good reasons for U.S. concern here, since the same country justification is based upon assumptions regarding the tax system of the country of incorporation. These assumptions are not always correct even without regard to the use of hybrid branches (many countries do not link residence to place of incorporation), but the hybrid branch technique can make them wrong all the time. The remedy might be to interpret the same country justification in terms of its original understanding—that the United States generally should be indifferent whether a taxpayer is operating in a single foreign country through two, rather than one, CFCs taxable on a residence basis. In that event, if the foreign country did not regard the hybrid branch as a resident taxable entity, the justification for deferral would not be available. To the extent the ossified statutory scheme does not permit such a policy-oriented interpretation, the United States surely has a strong interest in ensuring that hybrid branches do not permit the use of the same country justification in circumstances where its underlying rationale does not apply.

Since subpart F operates on the basis of evidentiary showings of a need to be abroad, and the foreign tax level has been relied on in these showings, it is possible to view the different uses of international tax arbitrage in this context in different ways. A justification based on a same country interest or dividend payment that the foreign country of incorporation does not perceive as a same country payment seems different from interest paid by a CFC that the foreign country of incorporation recognizes as deductible but whose existence the United States does not acknowledge. In the latter case, the payment merely serves to reduce the level of foreign tax, which may or may not be important for purposes of subpart F. In the former case, the arbitrage results in a perversion of the justification for deferral. This is because the same country justification rests, ultimately, upon the taxation rules of the country of incorporation, as opposed to the definitions and rules, including check-the-box rules, of the United States.

V. Remedies, Remedies

If, despite the skepticism expressed above, there does (or might, or should, or could) exist an “international tax system” calling for broad harmonization among nations and condemning, at least to some extent, international tax arbitrage and its uses, where would one find it?

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87 Thus, a same country payment of dividends or interest to a company incorporated in the same country as the payor but managed and controlled in a third country, and not considered a tax resident by the country of incorporation, presents the same issue identified in Notice 98-11, note 34.
No careful search or analysis is required for the conclusion that there is as yet no formal multilateral document that embodies such a system.\textsuperscript{88} Nor, in fact, are there encouraging pronouncements from national tax regimes to demonstrate that the system is a matter of common understanding.

One place to look, presumably, is the network of international tax conventions that indisputably does exist and that represents, cumulatively, a triumph of international law in the field of taxation. One important U.S. contribution to this formidable body of law is the addition to the title of the U.S. Model Income Tax Convention of a purpose "for . . . the prevention of fiscal evasion."\textsuperscript{89} Could it be that this phrase and all that flows from it give evidence of the international tax system that the Finance Committee invoked in 1986?

The difficulty with this hypothesis is that international tax conventions themselves usually make clear that they are elective: "The Convention shall not restrict in any manner any benefit now or hereafter accorded . . . by the laws of either Contracting State," in the words of the U.S. Model Treaty.\textsuperscript{90} This means, simply, that a taxpayer may reject a treaty and its contents and invoke instead its rights under domestic law, both in the United States and in the other country. Since international tax arbitrage generally (though perhaps not invariably) builds upon differences in domestic laws, not treaties, an election to rely on domestic law would leave the taxpayer with the same arbitrage opportunities as if the treaty did not exist at all. In other words, the treaties lack the leverage to implement an international tax system by striking at international tax arbitrage. The reference to fiscal evasion in the title of the U.S. Model Treaty refers not to some invisible set of transnational provisions but to the domestic laws of the treaty partners; the treaty is supposed to provide means for preventing taxpayers from evading such laws, and it accomplishes that task primarily through its provisions calling for exchange of tax information and the detailed rules governing the procedures and timing of that exchange.

\textsuperscript{88} The work of the Organisation for Economic Co-Operation and Development on "harmful tax competition" is aimed at achieving cooperation at a much higher level of tax policy than the detailed rules that give rise to the arbitrage discussed here. See generally OECD, Harmful Tax Competition: An Emerging Global Issue (1998). It does not appear realistic that efforts of this nature could ever eliminate the type of country differences identified previously in the text, and it is not even clear that such elimination is a desirable international goal.

\textsuperscript{89} U.S. Model Treaty, note 43.

\textsuperscript{90} Id. art. 1(2). In the United States, where the Constitution requires that revenue measures originate in the House of Representatives while the advice and consent power with respect to all conventions resides in the Senate and the House has no role in the process leading up to ratification, the elective nature of treaties arguably is constitutionally mandated.
This, of course, leaves the convention’s title with a clear meaning but, since arbitrage by definition does not involve evasion of the laws of any country, this meaning is distinct from any international tax system that would pertain to arbitrage.

The only remaining place in which the supposed international tax system could be found is the domestic laws of nations—in the United States, the Code. The comments offered previously suggest that the policy basis for rules targeting arbitrage seems insubstantial at best, and the line-drawing exercise appears daunting. Nevertheless, it is conceivable that Congress could strike a blow in favor of its international tax system by enacting appropriate legislation.

Section 1503(d) does not qualify as appropriate legislation. It is too narrow and specific in scope, and any conceivable goal of the section is too easily achieved by other means outside the rules that have been enacted, and interpreted, to date. If § 1503(d) is a correct reflection of a proper general purpose, the statute must be enlarged so that its prohibition of U.S. tax benefits applies in comparable arbitrage situations. And since there are many such situations, with new ones emerging on a regular basis, the enlargement arguably should be open-ended—with Treasury and the Service accorded discretion to define, by regulation or otherwise, those situations that run afoul of the policy course that Congress articulates. The alternative would be a long list of specific cases of arbitrage and jeopardized U.S. tax benefits, supplemented from time to time as new situations come to the attention of Congress.

Needless to say, there would be huge problems with either approach. It already has been suggested how any policy concerns that could underlie the DRC provisions extend broadly into other areas, tax and nontax. In these circumstances, line-drawing will border on the impossible, and proscribed arbitrage plays will make up a lengthy list. On the other hand, a statute according wide-ranging power to the Service to withdraw otherwise available U.S. tax benefits is certain to be viewed with horror by U.S. taxpayers and, presumably, by Congress.

What to do? A starting point might be for Congress to attempt once again to answer the underlying questions, raised but admittedly not disposed of in this essay, of whether we care about arbitrage and why. The exercise might enable tax policymakers either to press beyond DRCs into other specific areas or to make a thoughtful, and forthright, retreat. The shape of a sensible statutory provision in this area is not going to become clear unless and until there has been an intelligent explanation of purpose.
VI. Conclusion

International tax arbitrage, the deliberate exploitation of differences in national tax systems, is the planning focus of the future. This is not a passing fad, not a minor phenomenon. Thanks in large part to the tutelage of U.S. professionals, taxpayers throughout the world have become conscious of the many benefits of threading a course among domestic tax laws.

The question this essay asks is: So what? The policy response the United States has offered so far calls to mind a deer caught in headlights. If we have a legitimate concern about benefits obtained by taxpayers on income or activities not subject to U.S. jurisdiction, we should endeavor to explain coherently what that interest is. Invoking the international tax system does not constitute an explanation, since that system appears to be imaginary. Whether it would be desirable is a different question — but one bearing only marginally on the intensely practical world of international tax policy.