

INTERNATIONAL HYBRID INSTRUMENTS:  
JURISDICTION DEPENDENT  
CHARACTERIZATION

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TABLE OF CONTENTS

I.	INTRODUCTION .....	99
	A. <i>Hybrid</i> .....	100
	B. <i>Withholding Regime</i> .....	101
II.	DISCUSSION.....	103
	A. <i>Debt-Equity Classification</i> .....	103
	1. Consistency of Characterization.....	103
	2. Treasury's Response .....	104
	3. Recent Application .....	105
	4. Proposals to Repeal the Distinction.....	106
	5. Heightened Evidentiary Standard .....	106
	6. Effect of Mandated Disclosure.....	107
	(a) Promoter Registration Regulations .....	107
	(b) Tax Shelter Registration Regulations .....	107
III.	CROSS-BORDER APPLICATIONS.....	108
	A. <i>Hybrid Payments to U.S. Entities</i> .....	109
	B. <i>Hybrid Payments by U.S. Entities</i> .....	111
IV.	LEGISLATIVE PROPOSALS AND OPEN REGULATORY RESPONSES.....	114
V.	POLICY ANALYSIS AND RECOMMENDATIONS .....	115
	A. <i>Causes of International Tax Diversity</i> .....	115
	B. <i>Tax Arbitrage</i> .....	117
	1. Tax Payers' Motivations .....	117
	2. Challenges to Existing Tax Systems .....	118
	3. Potential Responses .....	119

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4. Underlying Network of International Treaties .....	120
5. Possibility of Judicial Response.....	122
6. Appropriateness of the Matching Principle.....	123
7. International Organizations as an Alternative.....	124
8. Appropriateness of Interest Deduction .....	125
VI.CONCLUSION .....	126

## I. INTRODUCTION

Double taxation occurs when two or more jurisdictions assert authority to tax income arising from a transaction without providing any relief for taxes paid elsewhere.<sup>1</sup> Because of the inconsistent source of income rules, for example, both jurisdictions may tax income without providing a credit for taxes paid on what each considers domestically sourced income. Although the interplay of the international tax systems frequently produces double taxation, it may also provide opportunities to minimize or eliminate the total international tax liability arising from a transaction.

When two or more jurisdictions treat the same transaction, instrument, or entity differently or inconsistently, opportunities to exploit the differences in tax systems arise. The goal of such exploitation, or tax arbitrage, is to obtain the tax benefits from a transaction in more than one jurisdiction. The differing views about the transaction, thus, can lead to both double taxation and opportunities for tax arbitrage.

An empirical look at the Treasury's attempts to curb such tax arbitrage in the past reveals that the regulation of the hybrid instruments not only is difficult, but also is likely to be futile and suffer from being both over and under-inclusive.<sup>2</sup> This Article reviews the legal background that gives rise to the possibility of tax arbitrage. While focusing on the increased international use of derivative and hybrid instruments in tax planning, the Article discusses the reasons for and concerns raised by the tax arbitrage through the lens of the US tax system, responses to the seemingly abusive tax arbitrage transactions, and the role that international tax treaties and international organizations can play in curbing such practices. Finally, the Article suggests a current course of action for the US Treasury based on

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1. See, *Texasgulf, Inc. v. United States*, 17 Cl. Ct. 275, 279 (1989).

2. Cf., Albertina M. Fernandez, *Eighth Annual GWU International Tax Conference*, 1 TAX NOTES INT'L 3 (1996) (showing an example of over-inclusive hybrid regulations and tax arbitrage opportunities).

differentiating the tax payers who take advantage of tax arbitrage by relying on an inconsistent factual characterization from those that do not.

### A. Hybrid

Business entities often possess jurisdiction dependent tax characteristics. When such entities are inconsistently characterized by the foreign and domestic tax laws, they are called “hybrid.”<sup>3</sup> They play a fundamental role in tax arbitrage transactions.<sup>4</sup> Although hybrid entities are not novel,<sup>5</sup> their use increased significantly when the Treasury released the check-the-box regulations,<sup>6</sup> which allowed a taxpayer to choose to be treated as a corporation or as a transparent entity for tax purposes.<sup>7</sup> Some commentators point out that check-the-box regulations, promulgated to improve the administrability of entity classification, reach too far by including foreign entities in their regulatory reach, thus creating additional opportunities for tax arbitrage.<sup>8</sup> Hybrid instruments are defined as financial

3. See, Gregg D. Lemein & John D. McDonald, *Final Code Sec. 984 Regulation: Treaty Benefits for Hybrid Entity Payments*, TAXES, Sept. 1, 2000, at 59.

4. See *id.* at 59.

5. See, e.g., *Arundel Co. v. United States*, 102 F. Supp. 1019 (Ct. Cl. 1952) (allowing a foreign tax credit to a Puerto Rican joint venture treated as a flow-through entity for U.S. tax purposes, yet subject to an entity level tax in Puerto Rico); *Abbot Labs. Int'l Co. v. United States*, 160 F. Supp. 321, 322, 325, 328 (N.D. Ill. 1958), *aff'd*, 267 F.2d 940 (7th Cir. 1959) (deciding a foreign tax credit case involving Argentinean and Columbian Sociedad Responsabilidad Limitada that were treated as corporations in U.S., but as flow-through entities for local law purposes); Rev. Rul. 72-197, 1972-1 C.B. 215 (1972) (dealing with a foreign tax credit issue with respect to a domestic unincorporated association taxed as a corporation for U.S. tax purposes, but as a partnership for foreign tax purposes).

6. See, Peter H. Blessing, *Final § 894(c)(2) Regulations*, 29 TAX MGMT. INT'L J. 499 (2000).

7. Treas. Reg. §§ 301.7701-3 (2004).

8. See, e.g., Fernandez, *supra* note 2 (reporting a worry that “applying the check-the-box proposal to foreign entities would open the floodgates to foreign partnerships that could then obtain tax benefits not available to corporations”); Kathleen Mathews, *IRS Official Discusses Check-the-Box Proposal for Foreign Entities*, 12 TAX NOTES INT'L 541, 541-42 (1996) (describing I.R.S.’ thinking in extending the treatment to foreign entities); *NYSBA Tax Section Strongly Endorses Check-the-Box Entity Classification Proposal*, 11 TAX NOTES INT'L 718, 718-719 (1995); see also discussion *infra* Part V. Compare, e.g., Victor E. Fleischer, Note: “If it Looks Like a Duck”: *Corporate Resemblance and Check-the-Box Elective Tax Classification*, 96 COLUM. L. REV. 518, 541-42, 547-49, 553-54 (1996) (concluding that on the domestic front check-the-box regime, because of its public trading exception, reasonably implements the congressional mandate to tax entities according to their resemblance to corporations or partnerships), with George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the “Check-the-Box” Regulations*, 51 SMU L. REV. 125, 129-33 (1997) (questioning the public trading exception

instruments that have both debt and equity characteristics and could potentially be classified as equity by one jurisdiction and as debt by another.<sup>9</sup> Hybrid instruments enable tax practitioners to create a class of transactions with disparate international tax treatment with respect to the “deductibility, inclusion, timing or character of payments made.”<sup>10</sup>

Such instruments also are widely used in tax arbitrage transactions, not only to provide desired characteristics not present in pure debt or equity instruments,<sup>11</sup> but also to reduce the cost of financing or to enhance returns by securing deductions in one jurisdiction without the inclusion of income in another.<sup>12</sup>

### B. *Withholding Regime*

According to U.S. Internal Revenue Code, nonresident aliens and foreign corporations that receive dividends, interest, rents, royalties and other fixed, determinable, annual or periodic (FDAP) U.S. source income are subject to a 30 percent withholding tax.<sup>13</sup> Foreign jurisdictions also impose similar withholding taxes on nonresidents who derive income sourced within their territory.<sup>14</sup>

Although the imposition of withholding taxes on domestically sourced payments to nonresidents is the result of the jurisdiction’s assertion of the primary taxing power over income from domestic sources, the payments to nonresidents may be additionally taxed by the recipient’s country.<sup>15</sup> Representing only one of the few circumstances in which a tax on gross income is imposed, the withholding tax is a result of the realities of a

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and finding no rational justification for electivity).

9. Peter J. Connors & Glenn H.J. Woll, *Hybrid Instruments – Current Issues*, 553 PLI/TAX 175, 181 (2002).

10. *Id.*

11. *Id.* There are non-tax reasons for desirability of the hybrid instruments. *Id.* For example, an investor in stock may want increased creditor rights, mandatory redemption, or profit sharing. *See, e.g., id.*

12. Lee A. Sheppard, *Turbo-Charged Income Stripping*, 235 TAX NOTES 4 (2002). Because of the interest deduction, I.R.C. § 163, and the dividend received deduction (DRD), I.R.C. §§ 243-246A, in most cases, raising capital through debt, and investing capital in equity, rather than in debt, are more tax-efficient for taxable entities.

13. *See* I.R.C. §§ 871, 881, 1441-42 (2002). *See also* Jefferson VanderWolk, *Offshore Funds and U.S. Withholding Tax: Navigating The New Regulations*, 88 TAX NOTES 1263, 1263-65 (2000) (discussing the effect of regulations promulgated under these sections on U.K., Luxembourg, and Irish collective investment vehicles); Kimberly S. Blanchard, *The Uncertain Withholding Tax Status on Foreign Investment Funds*, 90 TAX NOTES 251, 253 (2001) (describing the complexities that arise when both the § 894 treaty-based and § 1441 withholding regulations have to be applied together).

14. Lemein & McDonald, *supra* note 3, at 59.

15. *See id.*

limited power to enforce tax laws.<sup>16</sup> Because the cross-border enforcement of tax judgments is currently ineffective, practical problems of collecting an accrued tax liability with respect to domestic investment-type income earned by nonresidents warrant the imposition of the gross income withholding tax as a response to such problems.<sup>17</sup> Reductions in withholding taxes, effected by the network of bilateral income tax treaties, often reflect the agreement by a jurisdiction to concede its primary taxing power on income from domestic sources to its treaty partners, and are normally premised on the assumption that the treaty partners will assert taxing jurisdiction over such income.<sup>18</sup>

With the advent of the check-the-box regulations,<sup>19</sup> the above assumption is not necessarily correct in the case of hybrid entities, which are subject to taxation by some jurisdictions while being treated as “fiscally transparent” by others.<sup>20</sup> Using hybrid instruments or hybrid entities to funnel income to exploit the discrepancies between the tax regimes, thus reducing the effective tax rate imposed on the cross-border transactions, is therefore theoretically possible, provided the absence of a specific legislative or administrative prohibition. In the context of hybrid entities, I.R.C. § 894(c) and Treas. Reg. § 1.894-1(d) create prohibitions that limit the treaty benefits,<sup>21</sup> such as reduced withholding rates, when the treaty partner does not impose its

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16. See generally CHARLES H. GUSTAFSON ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS 196 (2001).

17. See *id.*

18. See generally Lemein & McDonald, *supra* note 3, at 59. See also discussion *infra* Part V.B(6) addressing the appropriateness of such presumption.

19. See *supra* text accompanying notes 6, 8.

20. An entity is “fiscally transparent,” according to regulations, to the extent the interest holder in the entity has to “separately take into account on a current basis [his] respective share of the item of income paid to the entity . . . and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity,” or if the income item is not separately taken into account, the interest holder is required “to take into account on a current basis [his] share of all income paid to the entity . . . and the item of income would not result in a different income tax liability for that interest holder from the liability that which would result if the item were separately stated.” Treas. Reg. § 1.894-1(b)(3)(ii)(A) (2000).

21. See, e.g., Carol Doran Klein & Diane L. Renfroe, *Section 894 Payments to Flow-Through Entities*, 26 TAX MGMT INT’L J. 547 (1997) (discussing the effect of the proposed regulations on the existing tax planning transactions); Blessing, *supra* note 6 (discussing the effect of the final regulations). See also Lee A. Sheppard, *Hybrid Problems Continue Under Improved Treaty Regulations*, 88 TAX NOTES 316, 317, 319-320 (2000) (pointing out some of issues that remained); Lewis J. Greenwald et al., *Section 894(c) Final Regs. Simplify Treaty-Benefit Rules for Income Paid to “Fiscally Transparent Entities”*, 11 J. INT’L TAX’N 28, 30 (2000).

taxing jurisdiction over the transaction.<sup>22</sup>

## II. DISCUSSION

### A. *Debt-Equity Classification*

Distinguishing between debt and equity is a matter of immense importance in creating international hybrid instruments. However, doing so is inherently difficult. As a result of financial innovation, contemporary instruments possess both debt and equity characteristics of varying magnitude<sup>23</sup> and thus are more easily placed on a “debt-equity continuum” rather than pigeonholed into pure debt or equity categories.<sup>24</sup> With that in mind, Congress tried to clarify the classification of instruments as either debt or equity<sup>25</sup> by using a factor-based approach,<sup>26</sup> and by authorizing the promulgation of regulations addressing the classification of instruments.<sup>27</sup>

#### 1. Consistency of Characterization

Fearing that issuers and holders could take inconsistent positions with respect to the same instrument, Congress made

22. See I.R.C. § 894(c)(1)(C) (2000). The legislative history makes clear that the treaty partner will be treated as “imposing” tax on the payment even though the tax may be reduced or eliminated by offsetting deductions or credits otherwise available. See H.R. Rep. No. 105-148, at 550 (1997). See also Robert Goulder, *Official Clarifies Regulations for Payments to Foreign Hybrids*, 89 TAX NOTES 605, 606 (2000) (stating the opinion of the attorney-adviser with the Treasury that the appropriate inquiry should be whether “country exerts meaningful taxing jurisdiction over the entity with respect to that payment”).

23. See discussion *infra* Part V.B(1) (explaining that the financial innovation introduced such variability of characteristics to address instrument issuers’ and holders’ desires to gain exposure to limited, precise, and quantifiable risks that could be effectively managed).

24. See, e.g., Henry T. C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333, 393 (1989) (stating that the problem of classifying financial products by a regulatory scheme is a mapping problem). The latter process is called “mapping.” William Powers, Jr., *Formalism and Nonformalism in Choice of Law Methodology*, 52 WASH. L. REV. 27, 30-31 (1976) (explaining that the mapping problem arises when a “formal rule” is used to determine results potentially making them contrary to the rule’s rationale). See also Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation’s Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1320 (1991) (stating further that the powerless analytical tools used by tax systems to respond to financial innovation cause tax uncertainty and market inefficiency).

25. In 1969, Congress added § 385 to the Internal Revenue Code. I.R.C. § 385 (2000).

26. See I.R.C. § 385(b). The factors include: (1) written payment terms, (2) subordination or preference, (3) debt to equity ratio, (4) convertibility into the stock, (5) pattern of ownership of stock and the interest in question. *Id.*

27. See *id.*

the issuer's characterization binding on the holders but not on the Treasury.<sup>28</sup> The legislative history suggests that this provision might not be applicable to cross border transactions.<sup>29</sup> It was Congress' view that the requirement of consistency in characterization of the publicly-traded instruments would lead to issuer honesty and would help achieve the intended tax treatment. However, as one commentator points out, the tax system suffers a revenue loss even if the characterizations are consistent because the instrument holders are usually tax-indifferent.<sup>30</sup>

## 2. Treasury's Response

Although no regulations that address the debt-equity classification have currently been promulgated,<sup>31</sup> case law provides ample guidance in this area.<sup>32</sup> The Treasury also

28. See *id.* § 385(c). The holder may take an inconsistent position if it provides notice to the Treasury that the issuer's characterization is not being followed. See *id.* § 385(c)(2). At least one taxpayer/interest holder was successful in employing the common law debt vs. equity analysis to treat an instrument inconsistently with the instrument's characterization by the related foreign issuer, after providing a § 385(c)(2) disclosure statement. See Field Serv. Adv. 1999-29-002 (Jan. 27, 1999), 1999 WL 525823 (IRS FSA). See also discussion *supra* Part II.A. In Chief Couns. Adv. 2001-34-004 (Aug. 24, 2001), 2001 IRS CCA LEXIS 87, at \*36-\*37, the I.R.S. stated that because the foreign perpetual debt issuer, see discussion *infra* Part II.A., was not subject to U.S. tax regime, that would have required it to take a position on how the instrument should be treated for U.S. tax purposes per I.R.C. § 385(c)(2), the instrument holder could take an inconsistent position even without filing the disclosure statement.

29. See H.R. Rep. No. 102-716, at 3-4 (1992). The legislators were concerned and addressed a situation in which "a corporate issuer may designate an instrument as debt and deduct as interest the amounts paid on the instrument, while a corporate holder may treat the instrument as equity and claim dividends received deduction with respect to the amounts paid on the instruments." *Id.* (emphasis added). The lawmakers assumed that both the issuer and holder are subject to U.S. tax jurisdiction. See also Gregg D. Lemein & John D. McDonald, *International Tax Watch: Cross-Border Hybrid Instruments*, TAXES, Nov. 1, 2001, at 5, 7; Philip R. West, *Foreign Law in U.S. International Taxation: The Search for Standards*, 3 FLA. TAX REV. 147, 182 n.119 (1996) (stating that, although severely limiting in domestic context, § 385(c) "has no effect on the treatment of an instrument under foreign law [and] does not limit the inconsistent treatment of a hybrid instrument under the laws of the United States and a foreign jurisdiction.").

30. See Lee. A. Sheppard, *News Analysis: A Closer Look at Turbocharged Income Stripping*, 28 TAX NOTES INT'L 1073, 1077-78 (2002) (stating that tax-exempt or foreign entities are considered to be tax indifferent).

31. See Adam O. Emmerich, *Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation*, 52 U. CHI. L. REV. 118, 118-19, 143 (1985) (describing the history of debt-equity classification, and proposing a test). The Treasury issued and subsequently withdrew debt instrument classification regulations in 1981. *Id.* at 118-19.

32. See, e.g., *Nestle Holdings Inc. v. Commissioner*, 70 T.C.M. (CCH) 682 (1992) (thwarting I.R.S.'s attempt to recast debt as equity in a "loan" made to an intermediate holding company, while finding a genuine indebtedness based on the commercial reality); *Full Serv. Beverage Co. v. Comm'r*, 69 T.C.M. (CCH) 2221 (1995) (refusing taxpayers

addressed a growth in the number of companies that treated instruments inconsistently for regulatory and financial reporting and tax purposes<sup>33</sup> by warning that it would “scrutinize instruments of this type” and by promulgating a factor-based test.<sup>34</sup> Specifically, the Treasury warned that instruments that are de facto payable in stock or have “unreasonably” long maturities will be recharacterized as equity.<sup>35</sup>

### 3. Recent Application

In 2001, the I.R.S. offered guidance in a case involving the issue of characterizing hybrid financial instruments as debt or equity.<sup>36</sup> The instrument paid quarterly interest and was exchangeable at maturity for referenced portfolio stock held by the issuer.<sup>37</sup> Based on a sliding scale, the exchange was subject to restrictions based on the share value on the maturity date.<sup>38</sup> Although not secured by the portfolio stock, the instruments had the same liquidation preference as the issuer’s unsecured debt, and carried no voting rights.<sup>39</sup> The instruments were characterized as debt for purposes of financial accounting, and were reported as a forward sale of the company’s stock for

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attempts to recharacterize preferred stock as debt because of the instrument’s form, subordination, management rights, parties’ intent, and taxpayer’s treatment elsewhere); *Hawaii Co. v. Commissioner*, 108 T.C.M. 590 (1997) (disallowing equity recharacterization because the taxpayer had not “demonstrated an honest and consistent” treatment of the transaction for tax and financial reporting purposes); *Laidlaw v. Comm’r*, 75 T.C.M. (CCH) 2598 (1998) (recharacterizing intragroup loans as equity and disallowing deductions by using a factor test). *See generally*, William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971).

33. *See* I.R.S. Notice 94-47, 1994-1 C.B. 357.

34. *See id.* The factors are similar to the common law debt-equity factors, *see generally*, *supra* note 32, and include: (1) unconditional promise to pay; (2) right to enforce principal and interest; (3) subordination; (4) management rights; (5) capitalization; (6) identity between holder and issuer’s stockholders; (7) the label placed upon the instrument; and (8) intended treatment for non-tax purposes. *See id.* It is unclear whether the last factor, i.e. intended “non-tax purposes, including regulatory, rating agency, or financial accounting purposes,” may be used by the I.R.S. to encompass intended inconsistent foreign tax treatment, thus thwarting attempts to manufacture disparate treatment of an international hybrid instrument. *See id.* (emphasis added); *see also* Lemein & McDonald, *supra* note 29.

35. *See* I.R.S. Notice 94-47, 1994-1 C.B. 357.

36. *See* Field Serv. Adv. 2001-31-015 (Aug. 30, 2001), 2001 WL 875296 (IRS FSA). In the same pronouncement, the I.R.S. addressed whether the hybrids were part of a straddle and thus subject to the capitalization rules. *See* I.R.C. §§ 1092, 263(g).

37. Field Serv. Adv. 2001-31-015.

38. *Id.* at 3. The holder of the hybrid instruments was subject to market risk on the referenced stock below a specified price, received cash or stock equal in value to the specified price if the stock value was within a specified range, and received a fraction of appreciation with respect to the referenced stock if it appreciated more than the specified range. *Id.*

39. *Id.*



regulatory purposes.<sup>40</sup> The I.R.S. applied the factors of Notice 94-47,<sup>41</sup> and concluded that the issued instruments were not debt for federal income tax purposes. As a result the interest payments were not deductible.<sup>42</sup>

#### 4. Proposals to Repeal the Distinction

The traditional notion of debtor-creditor relations defines shareholders as the owners of capital and debt holders as the suppliers of capital. A number of commentators have proposed to eliminate this debt-equity distinction, arguing that it cannot currently be justified.<sup>43</sup> Although these commentators may be correct in their assertion that eliminating the distinction would be desirable, overall efficiency will not necessarily increase if the other economic distortions that are prevalent in the tax system remain.<sup>44</sup>

#### 5. Heightened Evidentiary Standard

The debt-equity analysis is further compounded by a new judicial trend, which places increased evidentiary burdens on the taxpayers challenging the *form* of the transaction on the grounds that the transaction's *substance* should govern the tax treatment.<sup>45</sup> Because not all circuits have adopted this evidentiary rule, when not compelled to do otherwise,<sup>46</sup> the Tax Court applies a "strong proof" rule that is more rigorous than the preponderance of evidence standard, but less demanding than the rule accepted by the circuits following the new trend.<sup>47</sup>

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40. *Id.*

41. *See supra* notes 10-12 and accompanying text.

42. *See* Field Serv. Adv. 2001-31-015. The I.R.S. also concluded that the instruments were part of a straddle with respect to the referenced portfolio stock because the issuer reduced its downside risk. Although the periodic payments were not deductible, they were subject to capitalization under I.R.C. § 263(g) because the instruments were incurred to continue the issuer's investment in the related portfolio stock.

43. *See, e.g.*, Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1056-57 (2000).

44. *See generally* HARVEY S. ROSEN, PUBLIC FINANCE 307 (5th ed. 1999); R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956-57).

45. *See* Connors & Woll, *supra* note 9, at 183. The heightened evidentiary standard mandates evidence that would be sufficient to modify the agreement under state law, such as a showing of fraud. *See id.*; *see also* Comm'r v. Danielson, 378 F.2d 771, 777 (3d Cir. 1967).

46. *See* Golsen v. Comm'r, 54 T.C. 742, 756-57 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971) (requiring the Tax Court to follow the rule of the circuit to which appeal lies).

47. *See* Connors & Woll, *supra* note 9, at 183-84.

## 6. Effect of Mandated Disclosure

### (a) Promoter Registration Regulations

I.R.C. § 6111 requires tax shelter registration by the organizers of certain confidential arrangements.<sup>48</sup> The proposed regulations in this area include transactions that “lacked economic substance,”<sup>49</sup> i.e. if “the present value of the participant’s reasonably expected pre-tax profit (after taking into account foreign taxes as expenses and transaction costs) from the transaction is insignificant relative to the present value of the participant’s expected net Federal income tax savings from the transaction.”<sup>50</sup>

### (b) Tax Shelter Registration Regulations

The corporate tax shelter disclosure regulations issued under I.R.C. § 6011 also potentially target cross-border hybrid instruments.<sup>51</sup> A corporation must disclose its participation in a “reportable” or other transaction that has at least two of the certain tax shelter characteristics.<sup>52</sup> One of the characteristics is the presence of the tax indifferent party (*e.g.*, tax-exempt or foreign entity) for the purpose of obtaining more favorable U.S.

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48. I.R.C. § 6111(a)(1) (2000). A tax shelter is defined as any transaction:  
 (A) a significant purpose of the structure of which is the avoidance or evasion of Federal income tax for a direct or indirect participant which is a corporation,  
 (B) which is offered to any potential participant under conditions of confidentiality, and  
 (C) for which the tax shelter promoters may receive fees in excess of \$100,000 in the aggregate.

I.R.C. § 6111(d)(1). *See also* Treas. Reg. § 301.6111-2 (2004). Avoidance or evasion of U.S. income tax will be considered a “significant purpose of the transaction” if the transaction is either one of several “listed transactions” or it produces U.S. income tax benefits that constitute an “important part of the intended results” of the transaction, and the tax shelter promoter “reasonably expects,” the transaction to be presented to more than one potential participant. *Id.* § 301.6111-2(b)(3).

49. *See id.* § 301.6111-2T(b)(3)(i).

50. *Id.* If the transaction was in the form of borrowing it would have been considered to lack economic substance only if the present value of the tax deductions of the taxpayer-borrower “significantly exceeded” the pre-tax return of the lender. *Id.* § 301.6111-2T(b)(3)(ii) (2000).

51. *See* Treas. Reg. § 1.6011-4 (2004).

52. *See id.* § 1.6011-4(b). The temporary regulations used to list inconsistent tax treatment for U.S. and foreign tax purposes as one of the tax shelter characteristics. *See* T.D. 8877, 2000-11 I.R.B. 747, 748; T.D. 8961, 66 Treas. Dec. Int. Rev. 152 (2001). Although the reach of Treas. Reg. § 1.6011-4 is broad, exceptions exist for transactions undertaken in the ordinary course of business, which are consistent with customary commercial practice. *See* T.D. 8961, 66 Treas. Dec. Int. Rev. 152 (2001).

tax treatment than would be available without such party.<sup>53</sup>

According to one commentator, although the practitioners advising with respect to the tax consequences of using the hybrid instruments are weary of the ever-present uncertainty that the desired disparate tax classification will be achieved in both tax jurisdictions,<sup>54</sup> in most cases they do not have to advise their clients that the arrangement involving the hybrid instrument has to be specially reported to the U.S. tax authorities.<sup>55</sup> The Treasury decided to remove cross-border arbitrage as one of the tax shelter characteristics from the I.R.C. § 6011 disclosure regulations, with internal government opposition strongly arguing that the disclosure in the U.S. is appropriate because of the significant potential for tax abuse when the foreign taxes are avoided or minimized.<sup>56</sup>

### III. CROSS-BORDER APPLICATIONS

Hybrid instruments are utilized in the context of cross-border transactions to secure an interest deduction for a foreign entity,<sup>57</sup> while ensuring that the payments (which are treated as dividends with an indirect foreign tax credit)<sup>58</sup> are tax free to the U.S. entity.<sup>59</sup> Analogously, hybrid instruments could be used to

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53. See Treas. Reg. § 1.6011-4(b)(6).

54. See generally discussion *infra* Part I.B. addressing such transactions in more detail.

55. See Sheppard, *supra* note 30, at 1079-80.

56. See *id.* at 1080 (stating that the rhetorical question “what’s it to you?” raised by the taxpayers was the driving force behind the Treasury’s decision). See also *supra* note 53 and accompanying text. See also Sheppard, *supra* note 30, at 1080 (questioning the universality of such assumption).

57. See Connors & Woll, *supra* note 9, at 201. The foreign entity is most likely to be a subsidiary of the American parent corporation. *Id.* at 201-02. See also Robert Goulder, *IFA Conference - Panelists Debate Tax Aspects Of Hybrid Financial Instruments*, 88 TAX NOTES 1311, 1311-12 (2000) (describing instruments that would be treated as equity in the U.S., such as, German *jouissance shares* that generate deductible interest to issuers and dividend income to investors; French *obligations remboursables en actions* (ORAs), which though similar to share forwards, permit an interest deduction; Dutch perpetual debt that could be treated as equity; Belgian reverse exchangeable debt embedded with an option to convert to issuer equity). See generally Connors & Woll, *supra* note 9, at 218-234. See also Gerhard Opheikens & Anton Louwinger, *Dutch Revenue Won’t Issue Advance Rulings to Tax-Motivated Hybrids*, 2000 WORLDWIDE TAX DAILY 91-5 (2000) (describing recent regulatory anti-abuse steps taken by one foreign tax jurisdiction).

58. See I.R.C. §§ 901, 902, 960 (2000).

59. See Connors & Woll, *supra* note 9, at 201. Such structure could also be used to make advances by a U.S. parent to foreign subsidiaries. *Id.* at 202. If the equity treatment for U.S. and debt treatment for foreign tax purposes is successfully achieved, the payments would be considered deductible interest for foreign tax purposes and dividends includable in income with offsetting foreign tax credits for U.S. tax purposes. *Id.*

ensure the interest deductions in the U.S. on an instrument that is treated as debt, while allowing the foreign investor to avoid the tax on the payments that are classified as dividends for foreign tax purposes.<sup>60</sup>

### A. *Hybrid Payments to U.S. Entities*

Perpetual debt securities,<sup>61</sup> profit sharing loans,<sup>62</sup> and convertible debt instruments<sup>63</sup> are commonly utilized to create cross-border hybrid instruments.<sup>64</sup> Although perpetual debt is treated as debt in some jurisdictions, under U.S. principles, it most likely will be recharacterized as equity because of the equity-like attributes of the perpetual investment.<sup>65</sup> The U.S. holder of the perpetual debt will take the payments into income as dividends and will be entitled to the indirect foreign tax credit.<sup>66</sup> The taxpayers are generally successful in using

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60. See West, *supra* note 29, at 182; Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. REV. 79, 99-100. Hybrid entities may also be used to achieve a similar result, i.e. an interest deduction in one jurisdiction with no income inclusion elsewhere. See Charles B. Rangel & John Buckley, *Current International Tax Rules Provide Incentives for Moving Jobs Offshore*, House Committee on Ways and Means, I, 10, available at [http://www.house.gov/waysandmeans\\_democrats/trade/tax\\_subsidies\\_for\\_jobs\\_outsourcing\\_sent\\_to\\_bna.pdf](http://www.house.gov/waysandmeans_democrats/trade/tax_subsidies_for_jobs_outsourcing_sent_to_bna.pdf). If a foreign entity is owned by a U.S. corporation and is disregarded under U.S. tax laws, its borrowing and interest received from its U.S. parent will be disregarded for the U.S. tax purposes (i.e. no deduction for inter-company loans). See I.R.C. §§ 902, 960. If in the foreign jurisdiction the entity is respected, it would be entitled to the interest deduction. See *id.* Analogously, a foreign corporation can establish a hybrid entity that would lend money to U.S. affiliates, and be treated as a branch for U.S. and as a corporation for foreign tax purposes. See Rangel & Buckley, *supra*.

61. An investment instrument that pays income on the principal without a set maturity date. See Richard M. Rosenberg & Ronald B. Given, *Financially Troubled Banks: Private Solutions and Regulatory Alternatives*, 104 BANKING L.J. 284, 286 n.9.

62. An agreement to pay a fixed interest rate as well as a percentage of the profits from the obligor's business. See BLACK'S LAW DICTIONARY 1247 (8th ed. 2004).

63. Debt convertible into stock at issuer's discretion is usually used. 33A Am. Jur. 2d Federal Taxation ¶ 12454 (2004).

64. Sometimes the combinations of all or some of the three mentioned hybrids are used. See, e.g., Charles T. Plambeck & David M. Crowe, *Overview of the Taxation of Financial Instruments*, in 95 TAX NOTES INT'L 123-24 (1995) (describing "Exchangeable Capital Securities" (X-CAPS) marketed by Morgan Stanley, which were coupon-bearing, perpetual subordinated notes exchangeable at the discretion of the issuer into its perpetual preferred stock, and as of 1995 were treated as debt for U.K. and as equity for U.S. tax purposes).

65. See discussion *supra* Part II.A. addressing the debt-equity distinction.

66. Field Serv. Adv. 2001-48-039 (2001); Field Serv. Adv. 2002-05-031 (2001). The I.R.S. has provided some guidance with respect to the perpetual debt instruments in the context of international hybrid instruments. In Field Serv. Adv. 2001-48-039 (Nov. 30, 2001) and Field Serv. Adv. 2002-05-031 (Feb. 1, 2001), the Treasury stated that in the transaction where the foreign subsidiary of the U.S. parent issues perpetual debt (treated as debt for foreign tax law purposes) and the parent enters into the prepaid forward agreement to purchase the debt from the current holders, for U.S. tax purposes, the transaction will be bifurcated into a current equity investment by the U.S. parent in the

perpetual debt to achieve the inconsistent cross-border tax treatment, thus effectuating the desired tax arbitrage.<sup>67</sup>

The inconsistent treatment of profit sharing loans could also be exploited in creating cross-border hybrids. While some foreign jurisdictions treat such instruments as fixed interest debt with the share of profits being deductible, a profit sharing loan is likely to be treated as equity for U.S. tax purposes.<sup>68</sup> Therefore the payments would be treated as dividends with potential indirect foreign tax credits for U.S. tax purposes.

Debt that is convertible into equity at the discretion of the issuer is treated as debt in some foreign tax jurisdictions, while for U.S. tax purposes, debt that has to be converted into equity is likely to be treated as equity, unless the holder only has an option to convert.<sup>69</sup> The taxpayers are generally successful in using convertible debt to achieve tax arbitrage.<sup>70</sup>

To diminish the tax advantage that the U.S. companies could achieve by issuing hybrid instruments to their foreign subsidiaries, the Treasury promulgated the Controlled Foreign Corporation netting rules.<sup>71</sup> To minimize the occurrence of the transactions that produce little economic profit relative to the potential U.S. tax benefits, the I.R.S. also issued Notice 98-5<sup>72</sup> announcing that the foreign tax credit will be disallowed in certain transactions.<sup>73</sup>

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subsidiary to the extent it acquired part of the perpetual debt and the issuance of debt by the subsidiary. For U.S. tax purposes, a part of the interest paid by the subsidiary would be treated as an indirect dividend to the U.S. parent. Field Serv. Adv. 2001-48-039; Field Serv. Adv. 2002-05-031.

67. See, e.g., Chief Couns. Adv. 2001-34-004 (Aug. 24, 2001) (stating that despite the perpetual debt's characterization as debt for foreign tax purposes, the substance-over-form principles will not thwart the instrument holder's attempts to characterize it as equity for U.S. tax purposes, i.e. confirming that foreign country's fact-specific placement of an instrument on the debt-equity continuum is not relevant for U.S. taxpayers). See also *supra* note 28, discussing I.R.C. § 385(c)(2) consistency requirement in the cross-border context.

68. Especially if no enforceable obligation to pay back the principal exists.

69. If there is substantial certainty that the option will be exercised, I.R.C. § 163(l) disallows the interest deduction. See I.R.C. § 163(l) (2000).

70. See, e.g., Field Serv. Adv. 2001-45-005 (Nov. 9, 2001); Field Serv. Adv. 2002-06-010 (Feb. 8, 2002). In both cases, a U.S. corporation made a loan to its foreign subsidiary with interest payable in stock of the subsidiary, while entering into a forward contract to purchase its subsidiary's stock when the debt matures at the price equal to the principal of the debt. See Field Serv. Adv. 2001-45-005; Field Serv. Adv. 2002-06-010. Although for foreign tax law purposes the transactions were deemed to be debt, the I.R.S. applied integration principles and characterized them as equity. Cf. *supra* note 19.

71. See Treas. Reg. § 1.861-10(e) (2004) (requiring allocation of interest expenses to foreign source income earned on loans to controlled foreign corporations).

72. I.R.S. Notice 98-5, 1998-1 C.B. 334.

73. Such transactions include purchase of assets that produce income subject to

### B. *Hybrid Payments by U.S. Entities*

Tax arbitrage is also possible when the U.S. entities try to obtain financing from abroad, which maximizes the tax advantages arising from the transaction for both parties involved.<sup>74</sup> This method of financing ensures deductibility of the interest in the U.S., while allowing the foreign counterparty to treat the instrument as equity in its jurisdiction and rely on the foreign tax credit or equivalent regime.<sup>75</sup> Issuing an instrument that is treated as debt for U.S. tax purposes and as equity for foreign tax purposes is a natural choice.<sup>76</sup> Foreign corporations trying to finance their American operations have widely utilized the LLC structure, which was made less effective by I.R.C. § 894(c) and regulations promulgated thereunder.<sup>77</sup> According to some commentators, the use of the hybrid instruments could be used to achieve the same tax result as the hybrid entities achieved before the I.R.C. § 894 regulations went into effect.<sup>78</sup> Repurchase transactions (repos) are another example of a widely used vehicle to achieve a disparate international tax treatment and to effectuate the tax arbitrage.<sup>79</sup> Repurchase transactions involve the “sale” of stock by a U.S. corporation<sup>80</sup> to a foreign investor with a promise to reacquire the stock at a price higher

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foreign withholding tax and use of hybrids to generate foreign tax credits. *See id.* at 5-7. Some commentators doubt the validity of Notice 98-5. *See, e.g.,* Connors & Woll, *supra* note 9, at 206-07.

74. *See* Sheppard, *supra* note 30, at 1074.

75. *Id.*

76. A number of recent tax court decisions indicate that it will become increasingly difficult to treat a stock instrument as debt because of the heightened standard of proof required by the Tax Court when the taxpayer asserts that the instrument labeled as stock is in substance debt. *See* Full Serv. Beverage Co. v. Comm’r, 69 T.C.M. (CCH) 2221 (1995). *See also* discussion *supra* Part II.A(5).

77. The structure involved a treaty eligible foreign entity creating a U.S. LLC elected to be a partnership for U.S. purposes and treated as a corporation for foreign tax purposes. The Tax Section of the New York State Bar Association, *Withholding on U.S.-Source Investment Income Paid To ‘Fiscally Transparent’ Entities*, 77 TAX NOTES 609, 610 (1997) (describing and criticizing the I.R.C. § 894(c) regulations). Capital received by LLC from the foreign entity would be lent to foreign entity’s U.S. subsidiaries. Joel D. Kuntz & Robert J. Peroni, *U.S. International Taxation*, C4.04[4] Denial of Treaty Benefits for Certain Payments Through Hybrid Entities [New], at 5-44 (1991). The U.S. subsidiaries would be issuing debt for U.S. tax purposes, while the “interest” payments would flow through to the foreign entity as a share of LLC’s income. *Id.* Before I.R.C. § 894(c), the interest income would be entitled to a reduced withholding rate and repatriated income would be deemed to be exempted dividends pursuant to Canadian tax law. *Id.*

78. *See, e.g.,* Sheppard, *supra* note 30, at 1075; Plambeck & Crowe, *supra* note 64 (illustrating generally the equivalence of an interest in a corporation with an interest in an option, and an interest in a partnership with an interest in a forward contract).

79. *See* Sheppard, *supra* note 30, at 1074, 1075.

80. Connors, *supra* note 9, at 212. Usually portfolio stock or the stock of a subsidiary is used. Peter J. Connor, *Hybrid Instruments-Current Issues*, 553 PLI/TX 175, 177, 212 (2002).

than the sale price.<sup>81</sup> The economic substance of the transaction is debt financing in a form of a loan by the foreign investor.<sup>82</sup> A large progeny of U.S. case law and administrative rulings establish when a repurchase transaction would be deemed to be a loan for U.S. tax purposes.<sup>83</sup> For foreign tax purposes, the form of the repurchase transaction will most likely be respected,<sup>84</sup> unless the transaction is directly addressed by the tax treaty with the United States.<sup>85</sup>

Ways of avoiding the direct treaty prohibition of the repurchase transaction have been devised by taxpayers who employed the so-called deferred subscription agreements.<sup>86</sup> The transaction involves a U.S. subsidiary of a foreign parent corporation entering into a deferred subscription agreement to acquire shares of the same parent's foreign subsidiary.<sup>87</sup> Another

81. *See id.* Alternatively, if the securities have an interest or dividend stream associated with them, the repurchase price does not necessarily have to be higher because the lenders can instead retain the interest or dividends on the underlying securities during possession.

82. *Cf. Neb. Dep't of Revenue v. Loewenstein*, 513 U.S. 123, 125 (1994). For U.S. tax purposes, the borrower is deemed to be the owner of the securities, while the lender is considered to earn the yield or discount retained which is taxable as interest despite the label placed on the transaction. *Id.* (concluding that "states may tax interest income derived from repurchase agreements involving federal securities" because the interest earned on the securities is like an interest on a loan to a private party). *See also* Sheppard, *supra* note 30, at 1074.

83. *See* *Union Planters Nat'l Bank of Memphis v. U.S.*, 426 F.2d 115 (6th Cir. 1970); *Am. Nat'l Bank of Austin v. U.S.*, 421 F.2d 442 (5th Cir. 1970); Rev. Rul. 74-27, 1974-1 C.B. 24; Rev. Rul. 77-59, 1977-1 C.B. 196; Rev. Rul. 79-108, 1979-1 C.B. 75; Rev. Rul. 81-218, 1981-2 C.B. 43; Priv. Ltr. Rul. 81-13-118 (Jan. 5, 1981); *see also* Tech. Adv. Mem. 97-48-005 (Aug. 19, 1997) (sale-leaseback of aircraft treated as a loan transaction); Treas. Reg. § 1.861-2(a)(7) (2004) (defining substitute interest payment in repurchase transactions).

84. The United Kingdom, for example, treats repos as financing transactions, but only when the underlying securities are debt. *See U.K. Inland Revenue Publish Guidance on Manufactured Interest on U.K. Securities*, 2001 WORLDWIDE TAX DAILY 82-33 (Apr. 27, 2001). *See also* Sheppard, *supra* note 30, at 1075.

85. *See, e.g.,* Convention for the Avoidance of Double Taxation, Jul. 24, 2001, U.S.-U.K., art. 24, para. 4(c), *reprinted in* 2001 WORLDWIDE TAX DAILY 143-14 (July 25, 2001) (effectively precluding the tax arbitrage in the repo transactions by ensuring that both sides treat the income streams as interest). *See also* U.S. IRS Official Addresses Cross-Border Arbitrage Policy Issues, 2002 WORLDWIDE TAX DAILY 59-5 (Mar. 27, 2002) (describing a statement by the special counsel to the I.R.S. that no one should feel strongly if repos are taxed because the U.S. foregoes its tax jurisdiction to treaty partners on the premise that the transaction is taxed abroad and that the Treasury may consider putting provisions addressing repos or similar transactions in the future tax treaties). *See also* discussion *infra* Parts IV, V addressing the appropriateness of addressing tax arbitrage in treaties and the veracity of the foreign taxation premise.

86. *See* Sheppard, *supra* note 30, at 1075.

87. *Id.* (describing the transaction in detail). The deferred share subscription agreement usually specifies the subscription price deliverable after a substantial period of time for which financing is sought. *Id.*

foreign subsidiary of the same parent takes the deferred obligation to purchase shares upon itself in return for U.S. subsidiary's interest bearing debt obligation.<sup>88</sup> The resulting tax treatment sought is, as always, an interest deduction in U.S. and nonrecognition of income abroad with no withholding of interest payments.<sup>89</sup>

Another example of the hybrid instrument that became widely used in the 1980s (although not necessarily for reasons of tax arbitrage) is MIPS (monthly income preferred stock).<sup>90</sup> MIPS is treated as a debt instrument for tax purposes,<sup>91</sup> but it possesses strong equity characteristics that result in equity treatment for U.S. financial accounting purposes.<sup>92</sup> Although the Treasury was unsuccessful in passing the legislation to address the seemingly abusive MIPS by denying interest deductions for such instruments,<sup>93</sup> the I.R.S. sought to deny interest deductions for a number of issuers.<sup>94</sup> MIPS would be directly affected by one of the legislative proposals that came as a result of the Enron scandal.<sup>95</sup>

88. *Id.* The debt obligation of the U.S. subsidiary is sought to be treated as debt with deductible interest for U.S. tax purposes. For U.K. tax law purposes the payments made by the U.S. subsidiary are treated as payments for capital. Because the U.K. subsidiaries are considered to be members of the same control group, the issuance of shares qualifies for non-recognition treatment. *Id.* Cf. I.R.C. § 1032 (2000).

89. See Sheppard, *supra* note 30, at 1074-75.

90. See Peter J. Connors & Glenn H.J. Woll, *Hybrid Instruments – Current Issues*, 458 PLI/TAX 413, 433 (1999). The progeny of MIPS includes Quarterly Income Capital Securities (QICs), Quarterly Income Debt Securities (QUIDs), Preferred Capital Securities, Trust Originated Preferred Securities (TOPrS), and Trust Preferred Stock (TRUPS). See Mark P. Gergen & Paula Schmitz, *The Influence of Tax Law on Securities Innovation in the United States*, 52 TAX L. REV. 119, 134 n.58 (1997).

91. *National Association of Bond Lawyers Criticizes Application of Regs to Tax-exempt Obligations*, 62 TAX NOTES TODAY 30, § II(E) (1995). To achieve the debt treatment for purpose of U.S. tax law, the terms of such instruments are carefully scrutinized. *Loans and Preferred Securities are Debt*, 49 TAX NOTES TODAY 15, n.105 (1999).

92. See Gergen & Schmitz, *supra* note 90, at 132. The transactional structure involves a foreign partnership formed by the U.S. corporation that issues preferred interests to the investors, and lends the collected funds to the U.S. corporation, with terms of the debt arrangement closely tracking those of the issued preferred interests. See Lee A. Sheppard, *I.R.S. Attacks Enron MIPS*, 104 TAX NOTES TODAY 4 (1998).

93. See, e.g., *General Explanations of the Administration's Revenue Proposals*, 26 TAX NOTES TODAY 5 (1997).

94. See Sheppard, *supra* note 92, at 4. *But see* Tech. Adv. Mem. 1999-10-046 (Nov. 16, 1998) (blessing a MIPS that used a foreign LLC).

95. H.R. 3622, 107th Cong. (2002). This bill would amend I.R.C. § 163(l)(2) by disallowing an interest deduction to an SEC registrant for:

- (i) any indebtedness of such registrant if such indebtedness is not shown in the certified annual report as part of the total liabilities of such registrant, and
- (ii) any indebtedness of an off-balance sheet entity if the proceeds of the issuance of such indebtedness are used directly or indirectly to acquire



## IV. LEGISLATIVE PROPOSALS AND OPEN REGULATORY RESPONSES

The Clinton administration proposed legislative changes that would have affected the treatment of hybrid transactions in its 1999 budget,<sup>96</sup> by directing the Treasury to prescribe regulations clarifying the tax consequences for such transactions, as well as to state when the results intended by the transactions are inconsistent with the purposes of U.S. tax laws (and treaties).<sup>97</sup> Although the tax benefits were not proposed to be taken away based only on inconsistent treatment of entities, items, and transactions, hybrid transactions aimed at reducing foreign income without income pickup in U.S. were proposed to be scrutinized.<sup>98</sup>

In its 2000 budget, the administration proposed a “form consistency” requirement. Applicable only if the transaction involved “tax-indifferent” parties, the proposal would have prevented the taxpayer from taking a position that did not reflect the form of the transaction.<sup>99</sup> The Bush administration finalized the domestic reverse hybrid entity regulations proposed by the Clinton administration, but stopped short of explicitly addressing the hybrid instruments.<sup>100</sup> As a result of such inaction, the limitations of benefits provisions in the tax treaties,<sup>101</sup> in addition to performing their original function of preventing the withholding tax avoidance, have become overloaded with the instrument and entity classification issues not otherwise addressed by the tax system.<sup>102</sup> Although it is possible to address the perceived abuse arising from the international tax arbitrage (and specifically from the employment of the hybrid instruments) through the benefits provisions in the tax treaties,<sup>103</sup> such

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stock (or other ownership interest) in such registrant.

*Id.* See also discussion *infra* Part IV for other legislative proposals.

96. See *General Explanations of the Administration's Revenue Proposals*, 22 TAX NOTES TODAY 6 (1998).

97. *Id.*

98. See *id.*

99. See generally Kenneth L. Harris, *Should There Be a 'Form Consistency' Requirement? Danielson Revisited*, TAXES, Mar. 1, 2000, at 88, 117.

100. See, e.g., Sheppard, *supra* note 30, at 1076-77 (expressing dismay that only one type of “hybrid abuse” has been addressed and alleging that the Treasury officials decided to address the “easier and potentially more dangerous” issue of treaty abuse that resulted from the adoption and widespread use of the check-the-box system).

101. See, e.g., U.S. Model Income and Capital Tax Convention, art. 24 (1981).

102. See Sheppard, *supra* note 30, at 1078.

103. See, e.g., Convention for the Avoidance of Double Taxation, *supra* note 85, at para. 4(c) (addressing the repo transactions directly). See also discussion *supra* note 85 and accompanying text.

approach is impractical<sup>104</sup> and inconsistent with the tax treaties' general purpose.<sup>105</sup>

In addition to its ability to curb cross-border tax arbitrage by negotiating treaty provisions that target specific transactions, the Treasury enjoys a more direct broad rule-making authority in I.R.C. § 7701(l).<sup>106</sup> The Treasury can prevent potentially abusive cross-border transactions by recharacterizing any "multiple party financing" when, according to the Secretary, such recharacterization is "appropriate to prevent the avoidance of tax."<sup>107</sup> At least when the debt treatment for U.S. tax purposes is sought,<sup>108</sup> and is otherwise warranted, the Treasury may decide to recharacterize the transaction to stop the tax arbitrage,<sup>109</sup> or alternatively, to wait for other countries to adopt the tax treatment that is consistent with that in the U.S.<sup>110</sup>

## V. POLICY ANALYSIS AND RECOMMENDATIONS

### A. *Causes of International Tax Diversity*

Each tax jurisdiction makes a multitude of individualized policy choices when promulgating tax laws by making a trade off between the substance-over-form requirement and the need for an administrable tax system,<sup>111</sup> while taking into account the

104. See Sheppard, *supra* note 30, at 1078 (conjecturing that reopening treaty negotiations because of the perceived tax arbitrage is unrealistic and claiming that repo transactions were directly addressed by the latest U.S.-U.K. tax treaty only because *ex ante* both countries had the same view of such transactions). See also *supra* notes 84-85, 88 and accompanying text describing such provision and an emerged method of avoiding it.

105. See Sheppard, *supra* note 30, at 1078 (stating that the purpose of the tax treaties are to set broad principles and to allocate the taxing powers when the conflicting tax jurisdictions are asserted).

106. I.R.C. § 7701(l) (2003).

107. *Id.*

108. See discussion *supra* Part I.B.

109. See Sheppard, *supra* note 30, at 1079. One commentator points out that such recharacterization may make the tax treatment inconsistent with the economics of the transaction. *Id.* For example, to target the tax arbitrage achieved through the use of the repo transactions, the Treasury would have to depart from the current (and probably correct) treatment of such transactions as borrowing. *Id.*

110. *Id.*

111. See, e.g., Richard K. Gordon, *Methodology and Cultural Traits: Financing Privatization in Eastern Europe: Comparative Privatization: Financial and Tax Issues: Privatization and Legal Development*, 13 B.U. INT'L L.J. 367 (1995). The higher the level of formality is utilized in the tax rule, the easier it is to administer. *Id.* However an increasingly formalistic rule allows the taxpayers to engineer transactions that satisfy the formalistic requirements of the favorable tax treatment, but lack congruency with the economic realities of the transaction. *Id.*

systemic equity and efficiency considerations.<sup>112</sup> Such choices are complex and, depending on the existing economic circumstances underlying the instruments, entities, and transactions that are subject to the jurisdictional reach of the tax system at the time the tax rule is promulgated, the line drawing that results from the new or changed tax law leads to inherently country-specific tax environments.<sup>113</sup>

The path dependence of the financial engineering, product innovation processes, and the jurisdiction dependent stage of progression of these processes, additionally contribute to the tax diversity in the treatment of the hybrid instruments. The tax jurisdictions drastically differ in their attitude towards an understanding of the innovative financial products that allow complete separability and manipulability of the classic instruments' component parts and make the risk profile and tax-efficient characterization of such instruments effectively elective.<sup>114</sup> The resulting diversity in tax treatment unsurprisingly provides numerous opportunities for tax arbitrage.

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112. See, e.g., Comm'n of the Eur. Cmty., Report of the Committee of Independent Experts On Company Taxation (1992), reprinted in 36 TAX NOTES INT'L 15 (1992) ("the existing tax diversity across Community countries is the outcome of trade-offs between such considerations" as "economic efficiency, fairness, feasibility and acceptability of various taxes and types of tax measures"). See also *infra* notes 129-131 and accompanying text.

113. See, e.g., Comm'n of the Eur. Cmty., Report of the Committee of Independent Experts On Company Taxation (1992), reprinted in 36 TAX NOTES INT'L 15 (1992). Even in the domestic arena, there is no consistent theory mandating a particular way or methodology of drawing the lines for tax purposes. Compare, e.g., David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627 (1999), and David A. Weisbach, *An Efficiency Analysis of Line Drawing in the Tax Law*, 29 J. Legal Stud. 71 (2000) (describing a model of efficient line drawing in tax law, based on application of the methods of optimal commodity taxation to the income-tax world, in which the lines are drawn so that a transaction or item is taxed like its closest substitutes, where substitutability is based on non-tax criteria), with Herwig J. Schlunk, *Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?*, 80 TEX. L. REV. 859 (2002) (refuting Weisbach's model because income-tax items are costlessly separable and combinable in ways that commodities are not, which allows perfect substitutes to be taxed inconsistently, and alleging that the measure of substitutability of a tax item is not useful if the existing baseline items are already inconsistently taxed), with Emmerich, *supra* note 31, at 140 (stating that the corporate finance theory does not support a principled distinction between debt and equity for tax purposes). See generally Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460 (1993), for the proposition that the inconsistency in treatment of income-tax items provides an opportunity for financial engineering of new transactions with the tax treatment being effectively elective.

114. See generally John Neighbour, *Innovative Financial Instruments Challenge the Global Tax System*, 14 TAX NOTES INT'L 931 (1997).

## B. *Tax Arbitrage*

### 1. Tax Payers' Motivations

International tax arbitrage results from the intrinsic inconsistencies in the tax rules of the different countries and their exploitation by the sophisticated taxpayers.<sup>115</sup> What attracts the instrument issuers and holders to the financial innovation is not only potential tax savings, but also increased opportunities to analyze and manage intricate types of risk, which enable the instrument issuers successfully and profitably to market financial products with the risk profiles that are likely to be not just acceptable, but desirable on both sides of the transaction.<sup>116</sup>

Once the acceptable risk and return characteristics have been determined by the parties to a transaction, the tax planning alternatives are considered in light of the legal rules promulgated by the existing international tax systems. The main objective of such observation is to allocate the total income streams that arise from the cross-border transaction within a set of hybrid instruments and entities to minimize the resulting worldwide tax liability for a given risk of being subject to legislative or administrative anti-abuse response.<sup>117</sup>

Hybrid entities and instruments not only make such planning possible, but also make it increasingly efficient. The intellectual separability of risk-return determination and the *ex post* tax optimization is an important feature of contemporary planning that makes it defensible, if not justifiable. Such separability allows business transactions to be influenced to a smaller degree by the distortional effects that indisputably result when a line drawing tax regime is implemented in a purely domestic context.<sup>118</sup> Organizational and business efficiency are increased as a result of the decision making process that is dependent not on the content of the tax rules themselves, that

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115. *See id.*

116. *See generally id.*

117. *See* Plambeck & Crowe, *supra* note 64. *See also id.* at n.79 (describing such process in more lay terms as “hitting the right balance between greed and fear”).

118. *See id.* (stating that such separability of decision making leads to increased non-dependence of business strategy departments on tax departments, which is desirable). It is widely accepted that any tax regime has distortionary economic effects, but the tax jurisdictions tolerate the inefficiencies because (1) the collected revenue is often used to finance socially desirable projects, which might not be undertaken otherwise, (2) taxation has positive distributionary effects, and (3) taxation and government spending may be utilized to smooth out the business cycles.

might not even reflect the economic reality of the transactions,<sup>119</sup> but on the presence of the inconsistent and disparate tax rules in two or more jurisdictions.

## 2. Challenges to Existing Tax Systems

The diversity among the tax jurisdictions alone is insufficient to create opportunities for tax arbitrage. The asymmetries within the tax systems may arise when the tax and economic distinctions do not match, or when the tax law provides a distinction but the economics of the transaction do not warrant one, thus allowing the taxpayer to elect the tax result without varying his underlying economic position.<sup>120</sup> If such asymmetries of the two or more international tax systems are inconsistent, the arbitrage opportunities arise.<sup>121</sup>

In the case of hybrid instruments, the discrepancy between the economics of the innovative transaction and the tax treatment is most often created when the existing and settled<sup>122</sup> rules of the tax system are applied to a transaction that is unlike any other that the tax system dealt with before and that is not even comparable or capable of being analogized to any existing tax treatments. In such cases, the challenge of the tax systems is to produce a technique of taxing hybrid instruments that, while being integrated with the existing tax system, accords with the economics of the transaction enough not to unduly discourage the use of such instruments.<sup>123</sup> Such instruments, incidentally, help to ensure that the jurisdiction has ready access to capital at the competitive rates,<sup>124</sup> and therefore their use is generally desirable.

The difficulty and the resulting legal complexity that arise in characterizing the hybrid instruments for tax purposes is a direct result of trying to strike a delicate balance between the competing and often incompatible needs of encouraging the use and development of innovative financial instruments, while

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119. See discussion *infra* Part V.B(2).

120. See *id.*

121. See Plambeck & Crowe, *supra* note 64.

122. No tax system could ever be characterized as statically settled because of the constant process of loophole mining and loophole covering in which the tax payers and the tax authorities are constantly and persistently involved. See generally *supra* note 113 (discussing line drawing, but the tax systems tend to reach a more or less dynamically stable level of non-fundamental change).

123. See Neighbour, *supra* note 114, at 932.

124. See *id.*

protecting the tax base from the abusive transactions,<sup>125</sup> and attempting to advance the policy goals of encouraging savings and investment and discouraging cherry-picking activity,<sup>126</sup> while simultaneously “preserving an equitable sharing of the tax base between countries.”<sup>127</sup>

### 3. Potential Responses

The consequences of tax arbitrage presented concerns for the law makers for some time. The decisions about classifying instruments that are used in tax arbitrage and identifying the parties responsible for paying the taxes that arise from the use of the hybrid instrument are commonly made by fitting such instruments into existing tax rules and classifications.<sup>128</sup> The tax systems generally strive to achieve the four values – neutrality,<sup>129</sup> equity,<sup>130</sup> certainty, and administrability.<sup>131</sup> The existing values-rules framework is not effective, however, in classifying and characterizing the seeming impropriety that occurs as a result of tax arbitrage and, specifically, the use of hybrid instruments to achieve it.

The standard objections commonly raised against abusive tax planning are mostly inapplicable to tax arbitrage, which requires compliance with the tax rules in every jurisdiction where the transaction could potentially be implicated.<sup>132</sup> The diminished competitiveness of domestic entities that do not have

125. *See id.* at 932-33.

126. *See* Plambeck & Crowe, *supra* note 64. Although the latter policy goals are hopelessly subjective, the tax laws often implement formalistic distinctions to achieve them. *See Neighbour*, *supra* note 114, at 932-33 (discussing how the attempts in striking such a balance are rendered futile).

127. *See Neighbour*, *supra* note 114, at 933.

128. *See id.*, at 933-34; *see also* discussion Plambeck & Crowe, *infra* Part V.B(2).

129. *See Neighbour*, *supra* note 114, at 934. A neutral tax system ensures that economically equivalent instruments are taxed in the same way, whatever their legal form. *See id.* Neutrality raises the need to identify economic equivalence for hybrid instruments, which are by definition created to blur the boundaries of legal form and economic substance. *See id.* Additionally, legal form may affect the economic function (for example, should the difference in contractual rights between and regulatory restrictions placed on owning the underlying shares and owning a derivative suffice to warrant differential tax treatment?). *See id.*

130. *Id.* An equitable tax system balances the competing concerns of taxpayers (liberality and flexibility with no restrictions on the use and development of innovative products and tax administrations) and administrations (ensuring protection against arbitrage and abuse while ensuring that rules do not hinder innovation). *See generally id.*

131. *Id.* The clearer the system, the easier it is to administer and the lower the compliance burden is for the taxpayers. *See generally id.* Certainty in tax treatment, however, has to be balanced with the flexibility to allow for financial innovation. *See generally id.*

132. *See*, H. David Rosenbloom, *The David R. Tillinghast Lecture International Tax Arbitrage and the ‘International Tax System’*, 53 TAX L. REV. 137, 141-43 (2000).

access to conflicting tax systems, that could be leveraged against each other, and the inability to exploit them to reap the advantages of lower tax rates, cheaper financing costs, and higher returns are often raised by the opponents of the tax arbitrage.<sup>133</sup> Although the competitiveness argument is inherently appealing, it is not entirely clear what justifies denial of tax benefits in a jurisdiction simply because the taxpayer also enjoys tax benefits elsewhere.

Should a tax jurisdiction have an interest in the level of tax imposed on a nonresident in his country, or in the kinds of tax benefits enjoyed there with respect to income or activities not subject to the reach of jurisdiction's taxing power?<sup>134</sup> Such concerns are inappropriate, especially when denial of tax benefits is premised on the assertion of tax jurisdiction abroad, revealing it as almost an effort to ensure that the foreign tax authority collects taxes.<sup>135</sup>

#### 4. Underlying Network of International Treaties

Some commentators have argued that the network of bilateral tax treaties that currently exists constitutes an international tax regime that is underlaid by the "single tax" principle, which tax arbitrage directly violates.<sup>136</sup> The treaties are designed to prevent both double taxation and fiscal evasion (i.e. the process through which the transactions are not taxed at all).<sup>137</sup> Tax arbitrage, the argument usually proceeds, leads to increased after-tax returns that draw capital away from domestic uses and toward cross-border transactions, resulting in potential inefficiencies.<sup>138</sup> In addition, because domestic labor providers are less mobile, i.e. they cannot easily change the source of their income, only capital income earners can benefit from the tax arbitrage.<sup>139</sup>

Moreover, tax arbitrage violates the matching principle of the treaties by exploiting the unintended inconsistencies between the laws of two tax jurisdictions.<sup>140</sup> Reduced withholding rates,

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133. See *id.* at 143-47.

134. See *id.* at 149-51, 154. See also West, *supra* note 29, at 182 n.119. See also Sheppard, *supra* note 30, at 1079-80 (referring to the ever present taxpayer's question: "what's it to you?").

135. See Rosenbloom *supra* note 132, at 154-55.

136. See Reuven S. Avi-Yonah, *Commentary*, 53 TAX L. REV. 167, 169 (2000).

137. See *id.* at 171.

138. See *id.*

139. See *id.* at 171-72.

140. See *id.* at 174.

provided by the tax treaties, are generally believed to be the direct result of the countries' assumption that the income will be otherwise subject to either domestic or foreign tax.<sup>141</sup>

If the tax practitioners and scholars follow the lead of international relations experts who believe in the unenforceable yet binding reality of patterns, rules, and practices of international relations, they would be correct in characterizing the international bilateral tax treaty scheme as a truly global structure that has a definite potency. Such a potency could be relied upon in promulgating domestic tax rules that have an effect on both sides of international transactions despite the absence of a truly binding framework.<sup>142</sup> If such characterization is accepted as the correct one, the domestic rules addressing the cross-border transactions become, in a sense, a supplement to the generalized and shared norms that form the basis of the network of bilateral treaties.<sup>143</sup>

When negotiating the bilateral tax treaties, the administrative branches responsible for articulating the tax policies from both countries decide to provide certain limited tax benefits to a particular category of the international taxpayers.<sup>144</sup> Such decisions and the resulting jurisdictional coverage provided by the newly negotiated treaty are normally premised on the baseline features of the countries' tax systems, their relative negotiating power, and concessions granted during the negotiations.<sup>145</sup> If the taxpayers construct instruments that violate the fundamental presumptions taken as correct by the tax administrations when they negotiated the treaty, a "stronger basis" exists to deny the treaty benefits by premising the sought domestic tax treatment on the taxation abroad.<sup>146</sup>

The lack of enforceability associated with the network of bilateral tax treaties has significant practical effects for the tax jurisdictions. By relying on such an unenforceable framework, the taxing jurisdictions voluntarily limit the set of available responses to perceived abuses resulting from the tax arbitrage. The countries may exercise their discretion to terminate the

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141. See *id.* at 173.

142. See generally *id.* at 169-70 (arguing that bilateral tax treaties compose a regime of international tax law); Victor Thuronyi, *International Tax Cooperation and a Multilateral Treaty*, 26 BROOK. J. INT'L L. 1641, 1641 (2001) (stating that bilateral tax treaties are uniform because they are all virtually based on a single model treaty and thus constitute an international tax law regime).

143. See sources cited *supra* note 142.

144. See Thuronyi, *supra* note 140, at 1673.

145. See West, *supra* note 29, at 179.

146. See *id.*; see also *infra* Part V.B(6) (discussing the appropriateness of the matching principle).



existing treaties altogether or to renegotiate them, basing their decision on the grounds that, in the case of international tax arbitrage, significant double taxation, that originally justified a tax treaty between the jurisdictions, is nonexistent.<sup>147</sup> It would be difficult, if at all possible, to justify addressing tax arbitrage by selectively denying treaty benefits.<sup>148</sup> If the newly negotiated treaties explicitly conditioned their benefits on the imposition of taxes in the treaty partner jurisdictions, not only the determinations about the effects of the foreign law would become of key importance in determining the eligibility of the parties for the treaty benefits, but also the domestic tax treatment would become dependent on factual inquiries about the foreign tax law in addition to the inquires about the domestic tax principles.<sup>149</sup>

Although, in most cases, the bilateral treaty regime provides the tax treatment that is desirable on both sides of the cross-border transaction,<sup>150</sup> the tax treaty framework is not necessarily binding on the international taxpayers.<sup>151</sup> The electivity of the treaty framework's status for the taxpayers has prompted one commentator to claim that any support for a "single tax norm" arising from such regime is "more hortatory than established policy."<sup>152</sup> It is unlikely, then, that the principles underlying the framework of bilateral tax treaties would be sufficient to justify a halt on the proliferation of the tax arbitrage transactions that involve hybrid instruments.

## 5. Possibility of Judicial Response

The judiciary possesses a heightened degree of discretion that is appropriate in addressing the increased prevalence of the cross-border tax arbitrage transactions generally and those

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147. See West, *supra* note 29, at 181.

148. See *id.* at 180-81; see also discussion *supra* notes 85 (focusing on Treasury's latest efforts to curb a certain type of innovative transactions by addressing them in the provisions of a newly negotiated bilateral treaty), 107-110 (addressing another potential response available to the Treasury).

149. See West, *supra* note 29, at 182; see also Sheppard, *supra* note 30, at 1079.

150. See West, *supra* note 29, at 182. Reduced interest or dividends withholding rates, for example, increase the after tax returns on the capital, while simultaneously lowering the cost of raising capital. *Id.* Both sides of a cross-border transaction will share the tax savings arising from the lower withholding rates in proportion to their relative elasticities of supply and demand for capital. The availability of competitively priced financial instruments and the acceptability of the foreign withholding regime are likely to affect such relative elasticities.

151. See Thuronyi, *supra* note 140, at 1672.

152. See Ring, *supra* note 60, at 105 (2002); see also note 149 (describing equity and efficiency considerations that arise as a result of tax arbitrage).

involving hybrid instruments specifically.<sup>153</sup> When respecting the conventions, categorizations, and forms created by the tax system produces results that are “at odds with prevailing or proclaimed notions of [tax fairness]” (as ascertained by the relevant court),<sup>154</sup> the substance-over-form doctrine is usually applied by the courts.

In addition to being more difficult to apply to the cases of tax arbitrage,<sup>155</sup> the substance-over-form doctrine gives enormous and unchecked latitude to the judiciary to determine the fairness of a transaction from the tax system’s point of view.<sup>156</sup> Such judicial latitude may in part account for the prevalence of the “conclusory analysis” in the cases where the substance-over-form doctrine is applied.<sup>157</sup>

Additionally, the judges, who are generally educated in and knowledgeable about the domestic law, are likely to apply the domestically developed tax principles to address the perceived tax avoidance.<sup>158</sup> In the context of the bilateral tax treaties framework, such judicial application of diverse domestic tax principles<sup>159</sup> on an international scale will result in an inconsistent application of the treaty between the contracting states.<sup>160</sup>

The judicial interference provides an important systemic safety valve that is appropriate in addressing the egregious and flagrant cases of tax avoidance, but in the context of tax arbitrage, and especially when the bilateral tax treaties are involved,<sup>161</sup> the determinations affecting the jurisdiction’s international tax policy are better left to the administrative branch.

## 6. Appropriateness of the Matching Principle

An often voiced objection to the tax arbitrage transactions

153. See Ring, *supra* note 60, at 131-32.

154. See Geoffrey J. Lanning, *Tax Erosion and the Boot-Strap Sale of a Business*, 108 U. PA. L. REV. 623, n.32 (1960).

155. See *supra* note 132 and accompanying text (discussing the inapplicability of traditional tax objections to the tax arbitrage transactions).

156. See *id.*

157. See *id.*

158. See Robert Thornton Smith, *Tax Treaty Interpretation by The Judiciary*, 49 TAX LAW. 845 (1996).

159. See *supra* Part V.A. (discussing the causes for international tax diversity).

160. See Smith, *supra* note 158, at 873.

161. *Id.* If the judge were to refer to the non-imposition of taxes by the foreign authorities on a tax arbitrage transaction, or its foreign taxation at a lower rate, the taxpayer may be successful in questioning the authority of the judge to deny the treaty benefits. See *generally id.* (providing an exhaustive discussion of the legitimacy of a court sustaining a denial of treaty benefits).

involving hybrid instruments is that even though the domestic tax rules are not specifically conditional on a particular tax treatment under the foreign tax law, the rules are “implicitly” premised on a non-disparate treatment abroad.<sup>162</sup> As one commentator points out, “[u]nder this view, the [domestic] tax results properly may be altered if the foreign tax results are not as implicitly contemplated.”<sup>163</sup>

Such objections, raised against the tax arbitrage transactions, are weakened when the disparity in tax treatment results from the application of inconsistent tax laws to the fact pattern identically presented by the taxpayer in each jurisdiction.<sup>164</sup> The objections are correlatively strengthened when the disparity arises as a result of the taxpayer’s attempts to force the inconsistent *factual* views about the transaction in the jurisdictions.<sup>165</sup>

Absent the global tax law,<sup>166</sup> the application of the matching principle in the international tax environment can raise doubts regarding a jurisdiction’s legitimacy in taking steps to curb tax arbitrage. When the tax treatment provided by one jurisdiction does not depend on the tax consequences in any other jurisdiction, the legitimate objections to the tax arbitrage are generally weak, illegitimate, and not well supported.<sup>167</sup>

## 7. International Organizations as an Alternative

Other commentators point out that because the international bilateral tax treaty network lacks uniformity and completeness in coverage, the international organizations<sup>168</sup> may

162. See West, *supra* note 29, at 172.

163. See *id.*

164. See Daniel I. Halperin, *Are Anti-Abuse Rules Appropriate?*, 48 TAX LAW. 807, 810 (1995); see also *supra* notes 145-146 and accompanying text (stating that such implicit assumption could be extracted from the bilateral tax treaty negotiation process).

165. See Halperin, *supra* note 164, at 810. The latter case could be more easily characterized as tax evasion because the taxpayer is misrepresenting the facts underlying the transaction to at least one tax jurisdiction. *Id.* However, when the underlying facts of the transaction are fully disclosed to the tax authorities (but the tax treatment sought in the jurisdiction or already obtained in another one are not), the tax systems lack objections that could be raised to oppose the characterization. See, e.g., *supra* note 28 (describing U.S. tax authorities’ allowance of the inconsistent characterization for financing transaction when the characterization was otherwise warranted by the existing domestic tax law).

166. See *supra* Part V.B(4) (discussing attempts to extract such non-binding order from the framework of global bilateral income tax treaties).

167. See generally West, *supra* note 29, at 172-73.

168. OECD is one example of such an organization. See Neighbour, *supra* note 114, at 936.

and, in fact, do provide for an appropriate dialogue among the taxing jurisdictions about the ways of coordinating a response to the tax arbitrage.<sup>169</sup> Such dialogues are most likely to allow the taxing jurisdictions to avoid the “obvious pitfalls”<sup>170</sup> in creating the rules that address the innovative financial instruments in general and hybrid financial instruments in particular.

At least one commentator strongly questioned whether the international organizations can advance even more in addressing the challenges to the tax system presented by the innovative financial instruments by seeking a “greater coordination of legislative approaches, perhaps by agreeing on broad guidelines.”<sup>171</sup> Others pointed out that such advancement or an international agreement about any type of consistent anti-abuse rule is “an impractical utopian hope.”<sup>172</sup>

### 8. Appropriateness of Interest Deduction

Although neither legally well accepted interest deduction nor dividend received deduction<sup>173</sup> is explicitly conditioned on any particular treatment of the recipient's interest income under foreign law,<sup>174</sup> the general policy against allowing taxpayers to “whipsaw” the tax system might imply that the allowance of the interest deduction is premised on the fact that the interest is subject to tax when received.<sup>175</sup> Similarly, the dividends received deduction is rationalized as removing the burden of multiple taxation on the corporate entities that are meant to be subject to only two levels of tax.<sup>176</sup> Such burden is nonexistent when the earnings and profits are distributed to the interest holders and deducted from the taxable income.<sup>177</sup>

It is a well accepted doctrine of tax law that the literal compliance with the laws is usually accepted unless the result is unquestionably at odds with the legislative intent, and it is certain that “the transaction would have been explicitly carved out from the scope of the law had it been considered by the

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169. *Id.*

170. *Id.*

171. *Id.*

172. See David A. Ward, *Abuse of Tax Treaties*, in *ESSAYS ON INTERNATIONAL TAXATION* 397, 404 (Herbert A. Alpert & Kees van Raad eds., 1993).

173. See I.R.C. § 163 (2000) and I.R.C. §§ 243-246A (2000) respectively.

174. The taxpayers who engage in tax arbitrage involving hybrid instruments rely on such lack of explicitness in the law when structuring their transactions. See West, *supra* note 29, at 183.

175. *Id.*

176. *Id.*

177. *Id.*

legislators.”<sup>178</sup> Because nothing in the tax law itself suggests that the interest or dividends deductions are dependent on the tax treatment elsewhere, they cannot be refused just because the income stream is nontaxable in the interest holder’s hands.<sup>179</sup>

The promulgation of anti-abuse regulations addressing the use of the hybrid entities that are closely analogous<sup>180</sup> to hybrid instruments, but that received more administrative attention in recent years,<sup>181</sup> caused some commentators to point out to the Treasury that the problem with tax arbitrage that needs to be addressed is not the withholding tax avoidance, but rather the “[inappropriate] interest deduction.”<sup>182</sup> That is, if the Treasury is not ready to withstand the international and domestic backlash that would be caused by the conditioning of interest and dividend-received deductions on the foreign tax treatment, then it may try either to avail itself of the already available means of refusing the deductions<sup>183</sup> or to renegotiate the tax treaties by specifically addressing the tax arbitrage.<sup>184</sup>

## VI. CONCLUSION

The long standing and consistent treatment of some tax arbitrage transactions involving hybrid instruments is likely to make the government’s attempts to pursue them or to curb their use not only difficult, but futile.<sup>185</sup> By casting its wide anti-abuse net, the Treasury might end up preventing the transactions that have been set up by the taxpayers for real business reasons.<sup>186</sup> To address the tax arbitrage in a more focused manner, the Treasury should try to either differentiate between the taxpayers who try to present inconsistent *factual* characterization of the transaction or the underlying instrument in two jurisdictions and those who do not, or force the disclosure by the taxpayers who are aware that the foreign instrument issuers or foreign instrument

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178. *Id.* at 184.

179. *Id.*

180. *See* Plambeck & Crowe, *supra* note 64 (illustrating generally the equivalence of an interest in a corporation with an interest in an option, and an interest in a partnership with an interest in a forward contract).

181. *See supra* note 99 and accompanying text.

182. The Tax Section of the New York State Bar Association, *NYSBA Criticizes Proposed Regs on Special Antiabuse Rule*, 11 WORLDWIDE TAX DAILY 26 (2002).

183. *See* I.R.C. § 7701(l) (2003); *see also supra* notes 106-108 and accompanying text.

184. *See* Neighbour, *supra* note 114, at 936.

185. *See* Sheppard, *supra* note 30, at 1077.

186. *Id.* (providing U.S. treatment of repos as loans and of quasi-lending transactions as leases as examples of such settled expectations).

holders are treating the instrument differently from the *factual* standpoint.<sup>187</sup>

Another angle from which the Treasury may try to address the increased use of hybrid instruments is to disregard for tax purposes the formal existence of legal entities (in effect disturbing the longstanding presumption in the domestic context in favor of the separability of entities) within a single (effective) control group,<sup>188</sup> thus ignoring the existence of debt and disallowing interest deductions for such inter-company obligations.<sup>189</sup>

Finally, what the Treasury should do – and most likely will do – with respect to the proliferation of the tax arbitrage transactions, is nothing. It should do nothing because (1) they are not abusive from the tax point of view despite indications to the contrary, (2) they have positive business efficiency and economic effects, (3) they may not be deemed abusive unless specifically targeted by a legislation or administrative determinations, and (4) over time they came to be relied upon by the taxpayers to seek and obtain higher returns and desired risks characteristics. Such expectations are not only legitimate, but also present a lobbying burden that would be hard for the Treasury to overcome. Tax arbitrage that involves inconsistent presentation of the facts is more abusive and therefore should be easier to address through the more traditional anti-abuse means.

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187. See, e.g., *id.*; see also *supra* notes 162-163 and accompanying text (stating that the disparate tax treatment is warranted when it results from inconstant laws as opposed to inconsistent representation of facts by the taxpayer). Cf. *supra* notes 27, 66-67 (providing examples of Chief Counsel and Field Service Advice memoranda that confirm that the Treasury at least informally follows the policy of disregarding the foreign *legal* treatment of the hybrid instruments).

188. See Sheppard, *supra* note 30, at 1079. Most tax arbitrage transactions that involve hybrid instruments are dependent upon respect of entity forms within the international control groups. *Id.* at 1078.

189. See generally *id.*