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CURRENT PROBLEMS OF STRUCTURING PETRODOLLAR LOANS

By Stuart R. Singer*

Rarely, if ever, have we seen a world in which trade has been carried out and investments made across national frontiers through the medium of freely available convertible currencies. The growth of multinational corporations on a large scale has, in the middle of the twentieth century, put the problem of transferability, convertibility, and financing to the forefront of the businessman’s major problems. While it is true that the currencies of Western Europe and the other major trading partners of the United States are largely convertible for purposes of current account transactions, and while it is true that major banking groups have flooded the world with branches and other entities capable of making instant money transfers, nevertheless, businessmen today live in a world where exchange and currency controls are the rule rather than the exception. The problems of these controls, together with a cost engendered in taxation by one or more jurisdictions, make the transfer of funds and the building of financing packages as difficult today as any time in the last twenty years. As taxing statutes and exchange control regulations have been enacted, bankers and their advisors have responded, with greater or lesser efficiency and dispatch, with the creation of new types of financing packages suitable for multinational investment. At times aggressive and imaginative, these advisors have frequently been timid and prosaic in their schemes. One glaring example is the period from the enactment of the Interest Equalization Tax Extension Act of 1971 (permitting, for the first time, the issuance of Euro-currency bonds by U.S. corporations without the medium of an international finance subsidiary) to the time of the first actual issuance, nearly one year later. The principal reason for the delay was the feeling by “some bankers in Europe” that the new vehicle “might” prove unattractive to the customers of Swiss banking institutions. The ready and rapid success of the Revlon placement and other issues in the second half of 1972 served to eliminate these fears and most subsequent issues followed the lead in structuring the bonds accordingly. 2

Advisors have not been alone in building a record of uneven success.


Government officials have blown alternately hot and cold with respect to assisting U.S. corporations in obtaining foreign source funds for their operations.\(^3\) At times we have seen the Treasury at odds with other departments in the Government in spite of the fact that the balance of payments policy of the United States was, in theory, being determined by an interdepartmental group representing Treasury, Commerce, etc. The U.S. corporation seeking foreign source funds has frequently been caught in the middle of one of these policy shifts. From a period of active encouragement, beginning in 1965, of Euro-bond offerings, the Treasury moved to benevolent neutrality, and finally, in 1973, to a period of tacit opposition and moderate obstructionism.

The problem has been that governmental fiscal policies draw their inspiration from a number of theoretical bases. A government may alter its policies on taxation and exchange control for a number of reasons, including raising of revenue,\(^4\) a desire for tax "neutrality,"\(^5\) the protection of labor forces in the U.S. domestic market, the reduction or elimination of a balance of payments deficit, change in the money supply, etc. Frequently, an examination of any given revenue bill sitting in Congress will reveal proposals that combine these theories, sometimes even when the proposals have been made by the same legislator. The result has been a patchwork, inconsistent, and largely inadequate tax and exchange control regime which has neither served to raise revenue for the United States nor encouraged U.S. businesses to a more simple and ready access of foreign-source funds.

In this paper I have reviewed the history of this regulation (largely to point out how financing package plans are themselves a direct response to regulation by authorities) in the hope that, armed with this knowledge, we may be able to put together, in the late 1970's, the much more sophisticated packages that are evidently going to be required. Underscoring this should be the fact that, as mentioned above, regulation is the rule, not the exception, and counselors must learn to deal with it on a permanent basis.

I. SOME HISTORY

After the end of the Second World War, the capital needs of our major trading partners, the industrial nations of Western Europe, impelled the United States to use its own currency, not only as a pump primer in the redevelopment of internal economies, but also as a means of providing adequate liquidity for international transactions. This policy was carried

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4. This is true even though the neat formulae presented to Congress on the "revenue effect" of tax measures have recently come under attack.

5. "Neutrality," in this context, means a legal regime in which the only function of taxation is revenue raising and where business decisions are, of consequence, made for reasons other than taxes.
out largely through the means of the Marshall Plan of economic assistance, with a lesser role being played by the International Bank for Reconstruction and Development. In point of fact, the nations on the receiving end underwent economic growth to an extent foreseen by none of the planners in the immediate post-war period. It can even be said that within ten or twelve years the rebuilding stage had not only ended, but had given way to a plateau of development from which very substantial economic growth was now possible.

A. Outflow of Dollars: The Supply

At the beginning of 1958, most countries had returned to full peacetime economic normalcy, and many were experiencing spectacular growth, particularly West Germany and Japan. General DeGaulle assumed authority in France and enacted a number of political economic measures that directly and indirectly would permit the French economy to compete vigorously in this market. At about this time, all major Western European currencies had become substantially convertible for purposes of current transactions. The original policy of the U.S. government had not been reversed or retracted, with the result that European traders were still encouraged to make international payments outside that of their own domestic currencies — the U.S. dollar.

It is impossible to estimate with any exactness the total of dollars exported during the years from the end of the Second World War through 1958, but U.S. governmental expenditures on economic and military assistance probably made up the lion's share of the outflow. While U.S. corporate investment did not assume the proportions of the 1960's and 1970's, the amounts spent overseas by U.S. businessmen were by no means insubstantial. The problem of this situation was one which should have been foreseen by many — that of the level of U.S. deficits reaching a point high enough to undermine the confidence of foreign holders.

In this respect, it must be remembered that the pool of dollars cumulating outside of the United States served two principal functions. Not only were they the chief means of exchange for international business transactions (both public and private), but they also served as a major supplement to gold and gold certificates for the monetary reserves of many foreign countries. Undermining of confidence in the value and/or stability of the U.S. dollar would therefore manifest itself not only in normal market forces but in, presumably, political reaction.

B. Outflow of Dollars: The Demand

At the same time, a second significant force was serving to accelerate the outflow of currencies from the United States. For a variety of historical reasons, Western Europeans have not built a risk capital market as U.S. businessmen understand that term, and the enormous growth in the post-war years meant that many European enterprises, themselves
multinationals, were starved for long-term funds. Their most logical source was the U.S. capital market, and the years of the late 1950's and early 1960's saw sharp increases in sales of securities in New York by large European corporations. One result of U.S. portfolio investors placing their money in this way was to accelerate even further the very significant payment outflow from the United States.

C. Outflow of Dollars: Political Reaction

The result of these factors was that, for the first time, the United States government began to take steps, albeit in an uneven and unsystematic manner, to counter these deficits. Since it eschewed currency devaluation as both politically undesirable and probably ineffective, it was forced into:

6. One may ask if this was actually the case. Analysis may be possible by first positing the following model:

**Common Causes of Payments Deficit:**

1. Weakened competitive position in world market because of:
   a. inflation at home;
   b. production and distribution inefficiencies; and
   c. tariffs in export markets.
2. Government expenditures abroad, resulting in a net outflow from:
   a. economic aid not tied to purchase of grantor's goods; and
   b. military expenditures.
3. Private capital outflows, based on:
   a. higher rates of return abroad; and
   b. business acquisitions to ensure sources of supply.
4. Tourism expenditures on:
   a. goods and services abroad; and
   b. travel on foreign carriers.

**Corrective Measures**

1. Adjust the exchange rate to:
   a. freely fluctuating rates, determined strictly by supply and demand;
   b. an adjustable peg system, permitting periodic revaluation;
   c. pegged rates with flexible ranges permitted.
2. Adjust commercial policy:
   a. monetary policy by:
      1. changing domestic interest rates;
      2. changing the supply of money.
   b. fiscal policy by:
      1. raising taxes;
      2. changing Government spending policies.
   c. direct controls imposed on:
      1. money (exchange controls, interest equalization tax);
      2. goods (tariffs, quotas, price supports);
      3. people (travel restrictions).

The historical effectiveness of an exchange rate adjustment (combined with adequate safeguards against domestic inflation) as opposed to the other remedies, must be weighed against the fact that perhaps only a few countries would have accepted the new rate without adjustments on their own. This was no longer true, of course, ten years later when European inflation and other factors led many Europeans to press for a U.S. devaluation.
STRUCTURING PETRODOLLAR LOANS

a series of piecemeal measures which had, at best, only a moderate effect incountering the deficit.7

1963 through 1975

The beginning of the 1960's saw an enormous growth in internationalfinancial placements and a concomitant growth in the deficit of the U.S.balance of payments. The spectre of a unified European economiccommunity with a planned common currency underscored the need for theUnited States to take some sort of action. The action was twofold. Congressenacted legislation empowering the President to negotiate significant specificreductions in tariffs with the rest of the world. These discussions,referred to as the Kennedy Round, did lead to some reductions, althoughtheir real impact on the U.S. export performance (and therefore on theU.S. balance of payments deficit) remains unclear. The second step wasthe imposition of an excise tax on the acquisition, by U.S. citizens andresidents, of securities issued by foreign borrowers.8 The tax was highenough so that the door was effectively closed to most foreign companiesseeking to raise risk or debt capital in New York.

But the real impact of the interest equalization tax was what seemed at the time to be merely a side effect. For those European corporations seeking to place long-term bonds, there was no viable alternative to the New York markets. Accordingly, a new market was invented. Within three months of the effective date of the statute, an Italian highway agency placed a bond denominated in U.S. dollars and sold directly to European holders. In theory, European holders, both individual and corporate, had always held substantial amounts of funds; they simply had not had the means of exchange or investment available to place these with businessborrowers. The Euro-currency bond or Euro-bond sought to bridge this gap, this lack of a trading medium, by designing an issue streamlined enough to be sold directly to the investor, without the need for a complicated trading vehicle. More importantly, this first issue showed European multinationals that the dollars were available for their purposes, and that they needed only to construct types of paper and corporate vehicles suitabled to the transaction to obtain large portions of these funds.

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7. These included "buy-American" restrictions on foreign assistance and reduction of the duty-free allowance for returning tourists. For a more detailed analysis see HABERLER AND WILLETT, U.S. BALANCE-OF-PAYMENTS POLICIES AND INTERNATIONAL MONETARY REFORM (1968).

Triffin notes that while the net outflow of private capital was reduced from 4.5 billion in 1962 to 3.7 billion in 1963, the outflow of U.S.-owned funds increased sharply. The principal factor of deterioration certainly does not lie in the transactions on current account or on foreign aid, which show persistent and massive improvement during this period (deficits of $1.1 billion per year in 1950-54 and $0.2 billion in 1955-59, but surpluses of $1.8 billion in 1960-64, and $4 billion in 1964). It is, instead, the net outflows of private capital ($0.3 billion in 1955-59, $4.5 billion in 1960-64, and $5.6 billion in 1964). See TRIFIN, THE BALANCE OF PAYMENTS AND THE FOREIGN INVESTMENT POSITION OF THE UNITED STATES (1966).

One of the difficulties in trying to stem the tide of any phenomenon which is at least partly fluid is that the dam must cover all channels. At the same time that portfolio investors were being cut off, U.S. banks began to increase their business to foreign borrowers significantly, and this aspect of the flow was treated only after two more years had passed.

D. Size Of The Market

It is far from clear how sizable the actual Euro-dollar pool was at this time, although estimates have been made of up to ten or twelve billion dollars. The real owners of these funds are seldom identified, but presumably, they include such diverse types as Latin American industrialists, Middle Eastern sheiks, European businessmen, and the Soviet Union (anxious to reinvest foreign exchange earned in trading with the West). The standard to measure the growth of the pool is not dissimilar from that in measuring any other pool, that is to say, the willingness of the various wealth holders to keep their capital in dollars and to relend it within that particular market.

The significance of the 1963 Euro-bond placement was the creation, in the minds of the Euro-currency holders, of the existence of a market, as opposed to a mere pool of funds. Once created, this attitude and willingness to reinvest funds within the market could now cause it to grow geometrically (particularly since none of the lenders was subject to any national reserve requirements).

1965 through 1967

Although the direct relationship is less clear, the continued deterioration in the United States trade surplus played an important part in accelerating the imposition of controls on the part of the U.S. government. This reduction in surplus coincided in point of time with a great increase in direct investment in plant and equipment by U.S. business. It was this that led many economists and politicians to posit the theory that exports and direct investments might be, at least in part, alternative choices for many U.S. businessmen and that to discourage one was to encourage the other. Accordingly, it was argued that one realistic means of encouraging U.S. exports (in the face of relatively lower labor costs overseas vis-a-vis the United States) was the restriction of U.S. direct investments abroad. This contention has been the subject of a number of examinations, few of them particularly systematic, and none of them conclusive.

In any event, the United States reacted with the two-pronged program restricting both the largest U.S. corporations and U.S. banks lending overseas. Although these two particular sources of outflows were checked, once again the U.S. government had stemmed only one channel of the river.

without dealing with the remainder. In fact, one of the principal effects of
the program, which restricted only the few hundred top U.S. corporations,
was to encourage all the corporations not covered to steal a march on their
larger competitors and to open up shop overseas, which they could do
without restriction. At the beginning of 1965, the restricted companies
accounted for something over 90% of the total U.S. direct investment
abroad; by the end of 1967, this percentage had dropped to around 50%.10

Nevertheless, the 1965 restrictions were a significant block to certain
large U.S. corporations, and this restriction gave rise to one of the most
important technical developments in international financing, the so-called
international finance subsidiary bond placement. These vehicles, a combi-
nation of ancient statute, legal ingenuity, and tacit cooperation of the U.S.
Treasury, served to provide the restricted U.S. companies with a proper
means of continuing their financing of foreign operations (by using foreign-
source funds) within the letter and the spirit of the exchange restrictions.11
Once the phenomenon was shown to be viable for U.S. corporate borrowers,
however, it became immensely popular, and not always for corporations
seeking to work within the existing capital controls. The addition of U.S.
corporate borrowers to the European ones already existing in the Euro-
currency bond market meant that the demand for money was increasing
in that market and that interest rates would go up slightly. In addition,
corporations were also selling bonds convertible into common stock, thus
combining the bond market with the desire of European fund holders to
invest in the U.S. risk capital market.12 Finally, it is likely that the demand
for money by this new larger pool of corporate borrowers accelerated the
flow of loose funds around the world into places where they could be in-
vested in this market itself; the market was actually increasing to major
proportions from its humble beginnings as a stopgap, created to live within
the fiscal and monetary regulation. In fact, for a long period of time, it was
thought that the Euro-currency bond market would take on enormous
portions, develop after-markets, variable types of paper, etc. Although
much of this never came to pass, it is not clear that, given a few more years
of significant regulation, it would not have done so in due course.13

10. Statement of Charles E. Fiero, Director of the Office of Foreign Direct Investments,
before the Subcommittee on International Exchange and Payments of the Joint Economic
Committee, January 15, 1969.
12. The first Euro-bond sold by a U.S. corporate group, the Monsanto issue of October
20, 1965, was convertible into the common stock of the parent company.
13. Several attempts were made to create secondary markets in Euro-bonds, none particu-
larly successful. For all of its breadth, the bond market was never very deep and, historically,
was able to absorb only a limited amount of paper within a fixed time period. Furthermore,
the purchasers of these bonds appear to have been more interested in the trading in the
underlying common stock (in the case of convertibles) than in the trading of the bond itself.
One interesting sidelight was the marketing of a type of commercial paper in the Euro-
currency market. The underwriters obtained the necessary clearances of the various regula-
Toward the end of 1967, the U.S. balance of payments deficit reached the dimensions of a political crisis and the Government finally attempted to deal with a number of different channels of outflows at the same stroke. Still avoiding devaluation of the currency, measures included restriction of private capital investment overseas, a suggested tax on tourist spending overseas, and a suggested import tax. These last two were never enacted, since, like the devaluation of the currency, they were at that stage still politically impractical. Furthermore, if one accepts the theory that the principal cause of the continuing trade deficit was the domestic inflation (during the years since 1964, the export performance had remained relatively constant; it was the rapid increase in imported goods that resulted in the deterioration of the once significant trade surplus), then the real attack on the problem might have been to reduce those fiscal and monetary policies that were contributing to the enormous overheating of the U.S. domestic economy. The problem was that these too, fell into the area of politically undesirable steps. While many opposed the U.S. military action in Southeast Asia, few did so principally on the basis of the U.S. balance of payments.

But the much broader restrictions of the foreign direct investment program meant that once again, large numbers of businesses were forced to look outside normal channels for their major long-range financing. Just as the 1965 program had stimulated U.S. corporations into using the medium Euro-currency bond market, so did the 1968 program stimulate the the medium-sized U.S. corporations into employing short and medium term bank and private placement financing for these same purposes. Although no specific structural vehicle can be said to have been produced at this time as a direct result of this program, two important variations did arise.

The first variation was a much greater use of international banking channels as sources of, and conduits for short- and medium-term funds. Most of the present-day arsenal of Euro-currency bank placements were born during the first two years of the 1968 program. Secondly, the international finance subsidiary, first developed in 1965, underwent a significant mutation to provide long-term funds in the United States for a number of U.S. corporations.

17. See INT. REV. CODE of 1954, §861(a)(1)(c) and §1441; Rev. Proc. 66-40, 1966-2 Cum. BULL. 1245. Also see Treaty with the Netherlands on Double Taxation, April 29, 1948 [1947],
1974 through 1975

From January, through the end of June in 1974, the unreality of the game of international finance structures reached new heights. Section 4912(c)(3) of the Internal Revenue Code permitted investors to cause the interest equalization tax to apply to designated securities issued by them even though the actual tax on such securities — and presumably, the consequent effect on the market for such securities — was negligible. Nevertheless, the Treasury insisted that the statute was still vital as investors continued to use the device, and it was felt that the various interested parties would manage to replace the existing structures with a more comprehensive one by the end of June, the date of the expiration of the Act.

The result of all this effort of tax advisors and government representatives was almost shockingly thin, particularly in the light of increased interest by foreigners in investment in the United States. The use of the taxing authority to regulate flows of funds across borders probably creates more problems than it solves; may distort normal patterns of investment; and may be among the most inefficient ways of effecting substantive political and social change. The massive expenditure of time and money by those involved in the creation and regulation of tax law has been exceeded perhaps in only one area, that body of law establishing and regulating our best known white elephant, the DISC.

II. The Present Era

It is to be left to future generations of practitioners and scholars to assess whether the combination of overaction and neglect was, in the long run, benign or harmful. For our purposes, the years 1963 through 1974 serve as a backdrop of tax regulation against which we must create and operate within structures for the latter half of the 1970's. At this point, therefore, it is necessary to examine the business and financial forces behind the various types of borrowings and investments since these too, have changed dramatically since the late sixties and early 1970's.

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A. Sources Of Fund Placements

At the simplest level, people who hold excess liquidity can supply funds, at a profit, to people requiring liquidity for capital investment purposes. The most common means is any commercial or governmental banking system. In spite of the myriad of controls which obtains when transferring funds across jurisdictions, the medium of the multinational banking system remains (and in theory ought to be) available to channel the vast majority of available petrodollar funds. The difficulty in this case has been the traditional unwillingness of most of the holders of petrodollar funds to employ these channels. This may reflect a lack of confidence in banks controlled by Westerners, or simply a desire to place investment funds directly in the country where they are to be ultimately used. It would seem probable that this situation will become more and more limited in the future as the multinational banks become more established and more sophisticated in the Middle East, as petrodollar holders establish their own financial institutions to act in the stead of banks, and as these holders gain more confidence in existing banking circles. Nevertheless, such a situation is probably several years away and it is not clear that the combination of various banking channels will ever assume the responsibility for gathering and investing the vast majority of available petrodollar funds. Therefore, when we analyze the role of banks for purposes of our legal analysis of the placement problems, we are talking about banks in their capacity as agents or brokers in the money market.

A second role of banks is to be a passive holder of deposits, the disposition and investment of which are determined by other entities. A third source of fund placements may be the so-called free-lance operator in the Euro-currency market (usually London, but also Singapore and Beirut) that looks for sources and placement availabilities like any other broker in any other volatile market. The final source of funds, for the U.S. based corporation, is the borrowers themselves, with the only medium being an artificial structure.

B. Summary Of Existing Mechanisms For Placements

Before discussing the structures which may be suitable for petrodollar financings, we must consider the role of two potential developments. Two possibilities remain that may obviate the necessity of much of the structural planning. The first is the potential reduction of circumstances in which the U.S. will impose an income tax on foreign recipients of U.S.-source interest and dividend income. The second is the creation by the U.S. government of structures designed to absorb investment funds in the U.S. and to apply them to businesses therein. What seemed to be the most promising possibility a few years ago, a joint project of the Treasury and the Securities and Exchange Commission for a regulated “off-shore” mu-

tual fund, has lain dormant since that time, and it is not clear that this is a reasonable possibility on which advisors can plan. Thus, the examination of the technical problem of the structures themselves is, of necessity, focused on the transaction between petrodollar holder and investment dollar user, with the only intermediary being a controlled structure or a third party acting as such.

C. Taxation Of Debt Placements

Direct Loans

The regulation of the transfer of capital and the repayment of interest on any loan made directly between the investing entity and the U.S. borrower will ordinarily mean that the interest payment is taxable to the recipient and is a tax deduction to the borrower. Unless the creditor falls within one of the relatively narrow exceptions outlined in the Internal Revenue Code, it will be taxed at a rate equal to 30% of gross income received.23 This rule is frequently modified by the United States when the interest income is paid to an entity resident in a jurisdiction which has concluded a double taxation agreement with the U.S. More importantly for current plans, it is the policy of the United States to negotiate wherever possible, for a reduction to zero on withholding tax imposed on both dividend and interest income. Apparently, according to Treasury officials, relatively recent treaties which have not eliminated this tax entirely have been due to the opposition of the foreign country, not that of the United States.

The problem is the unavailability of relevant treaties for most of our placements. To date there is no double taxation treaty between the United States and any petroleum exporting country (although one should be concluded with Iran in the near future). The result is that the successful use of an existing treaty presupposes that one additional corporation, related or unrelated as the case may be, must be added to the chain of entities in the transfer of loan principal and retransfer of interest payments on the debt. The proposed transaction in this case involves the establishment by the creditor of a resident entity in a jurisdiction which has concluded a tax treaty with the United States. For example, a Kuwaiti company may establish an operating branch in the United Kingdom which transfers the loan principal to a U.S. borrower and receives the interest payments therefrom. The issue is whether the U.K. branch of the Kuwaiti corporation is entitled to the benefits of the U.K.-U.S. double taxation treaty which would, if applicable, provide that the interest payments from the United States to the United Kingdom are not subject to U.S. income withholding tax at all.24

Generalizations about tax effects of double tax treaties are dangerous; treaties have been negotiated over a long period of time, during many changes in national treaty policy and sophistication in draftsmanship. Thus, a relatively old treaty, such as the U.K.-U.S. one, may provide a number of traps for the tax advisor not considering its provisions in exact detail. Every treaty provides within its own articles three types of “coverage.” These are (1) the taxes which are regulated by the treaty, (2) jurisdiction of the treaty, and (3) individual entities (or taxpayers) regulated. The first, in the case of the United States, usually is limited to the Federal income tax; in the case of certain foreign jurisdictions other taxes may be added (for example, certain capital taxes, the French stock transfer tax and the Netherlands property and capital tax). Furthermore, certain treaties provide that should existing income tax laws be abrogated in favor of a subsequent statute which, in effect, takes over the function of those existing taxes, the new taxes would themselves be regulated by the existing treaty.

In the case of jurisdictions, the usual rule is to limit the jurisdiction of the treaty to the so-called metropole, although in certain instances this may be extended to certain overseas territories, trusteeships, or departments by special protocol or amendment to the treaty. A particular problem has arisen in the inclusion or exclusion of those areas known as the Continental Shelf claimed by certain jurisdictions. In the Internal Revenue Code, the Continental Shelf is includable as U.S. national territory and is defined as:

[T]he territorial sea thereof (and) the seabed and subsoil of the adjacent submarine areas beyond the territorial sea over which the U.S. exercises sovereign rights in accordance with international law.

The difficulty with this definition is that the international law on the question is far from clear. The mechanical definition of the “Continental Shelf” was developed by the United States to deal with a problem of jurisdiction and/or sovereignty between the federal government and the states and dealt principally with the Caribbean and the Gulf of Mexico. The use of the “shelf” definition is not nearly so convenient in parts of the world where the geological structure may differ markedly. For example, the use of this same standard in the Persian Gulf might extend the sover-

eighty of certain countries to a point reaching half way to the South Pole. Therefore, other definitions of "soveriegn territory" have been suggested, including actual distance limit from the seashore (roughly equivalent to 200 miles) and certain restricted sovereignty exercises, e.g., solely for oil drilling, solely for off-shore platforms, solely for fishing rights, etc.

For our purposes, the critical definition in this example is not the question of jurisdiction (since we may posit that our branch will be located in the city of London), but one of taxpayers covered. The issue of whether a U.K. branch of a foreign corporation was to be entitled to the benefits of the U.S.-U.K. double taxation treaty was, prior to 1972, the subject of a great deal of abuse by practitioners. Mechanically, it is the law of the treaty which provides the terms of its coverage. Thus, the treaty provides that all taxpayers in the United Kingdom who are "resident" therein may avail themselves of the benefits of the treaty. The question of "residency" in the United Kingdom, however, is one to be determined under local U.K. law. As a general rule, a company is to be considered resident in that jurisdiction when it is considered "to be managed and controlled" in the United Kingdom. Taking this a step further, a company whose principal place of business is not within the United Kingdom, whose headquarters of operations (siège social) is not in the United Kingdom, and whose place of management is not in the United Kingdom would ordinarily not be considered managed and controlled in the United Kingdom. It would appear that in the case of non-U.K. corporations, only those for whom the preponderant majority of operations is located solely within the United Kingdom would appear to qualify. Thus, our Kuwaiti company would unquestionably not be entitled to the withholding tax exemption under the U.S. treaty.

In 1972, Revenue Ruling 72-378 outlined the basic fact situation mentioned above and underscored the existing rule of domestic U.K. taxation and its consequence to the U.K.-U.S. treaty. A year later, the obvious exception to that rule was restated in a subsequent revenue ruling. It is to be emphasized that although such rulings are helpful, they point out two interesting facts. First, practitioners have attempted to take advantage of the treaties without a careful examination of the law under which they operate; and secondly, the rulings themselves cannot do anything more
than restate an existing rule. They cannot, for example, discuss the United Kingdom law on "managed and controlled" with respect to very detailed fact situations. Rather, they simply restate a position based on an already existing conclusion of U.K. law. Any but the most simple of structures should, therefore, be passed on by tax advisors practicing in the jurisdiction whose law governs.

Interest Income to a Bank

If we are unable to use a U.K. branch of a Kuwaiti corporation, it might be possible to use a bank owned by our creditor (or in partnership with our creditor) for which the interest would be a different type of income than it would be to the creditor directly. Here we are in the realm of anticipation of future law, both domestic and by treaty. The receipt of interest by a bank or other financial institution has never been treated adequately by either double taxation treaty or internal tax law. If the United States should propose a statutory change eliminating withholding tax to foreign recipients on interest paid on certain portfolio investments, it could, with equal validity, enact either a statutory change or a change to the regulations which would provide that interest received by foreign financial institutions (not doing business in the United States), would be treated in the same manner as payments to a foreign manufacturer for the sale of goods into the United States. If the transaction could take place in such a manner that title passage, negotiations, and conclusion of the original contract were to take place outside of the United States, the amount might not be taxable at all. This would be done by treating financial institution income across national borders in roughly the same manner as it is treated within the United States.

The receipt of such income by a financial institution in a situation where income is paid from one treaty country to another would then, presumably, be treated as the receipt of industrial and commercial profits by the creditor institution, with all of the implications of that term in all of the existing tax treaties. Historically, there have been few actual or usable definitions of industrial and commercial profits. Even the OECD Model Draft (article 21) backs off from a precise consideration of interest by analysis of the nature of the recipient, rather than analysis of the nature of the income. Turning to examples of U.S. treaties: in the U.S.-Japan treaty, industrial and commercial profits specifically includes passive income from leasing operations;32 the U.S.-Norway treaty provides that industrial and commercial profits include income from leasing and film rentals;33 and the U.S.-Belgium treaty provides that industrial and commercial profits

include income from film rentals. In the case of income accruing to banks and similar financial institutions, there is no specific provision in any of the existing U.S. income tax treaties, although certain treaties between other countries do so provide.

Precedent for the separate treatment of interest paid to a financial institution arises in the Internal Revenue Code of 1954 under Sections 951ff, 901, 904(g), etc. It would seem that the real distinction is not the legal nature of the payment but the nature of the income to the recipient, that is to say, whether it is active or passive income.

There is but little law on the subject, and it suggests the confusion in which we currently find ourselves. On the one hand, where the transaction involves payments that are paid out and received within the United States (even if the payor or the payee may be related to a foreigner), it will be analyzed on an "active-passive" basis, whereas direct transactions between a U.S. entity and a foreign entity may be treated on the other basis. This would suggest that while the more progressive view may have the sympathy of courts in a position to take that view, the attitude of the Treasury with respect to transactions with a foreign entity seems to be that any change must be the subject of actual treaty negotiations and will not be effected unilaterally by the United States.

Thus, two possibilities may have been largely eliminated, the use of a branch in the United Kingdom and the use of a Kuwaiti bank or similar financial institution. A third means of reduction of withholding tax on interest paid directly to our Kuwaiti entity is the possibility that the Kuwaiti corporation is, in effect, an agency of a foreign government and is entitled to the exclusion provisions of the Internal Revenue Code which reflect classic international law on sovereign immunity. That statute, Internal Revenue Code, section 892, provides that income of foreign governments and their agencies shall be exempt from taxation by the United States unless (and here again it reflects a classic distinction in international law) the owner of the income is not a "corporation" as that term is understood in the United States. Therefore, while the French government may not be taxed on short-term deposits it holds in the United States for maintenance of its embassies and missions therein, it may be taxable on income derived from such things as a state-owned shipping corporation, airline, trading corporation, etc.

The question is now whether a financing agency of the Kuwaiti government might be considered a "governmental agency" entitled to the

benefits of section 892. One simple guideline, used both in international law and in the regulations under section 892, is whether the function of the owner of the income is the accumulation of profit or the performance of a function which is "governmental" in nature. It would seem, without careful examination, that the investment of petroleum exporting revenues per se, would not ordinarily be entitled to the government-type exclusion granted by section 892. On the other hand, international law in this area is not detailed, and it might be possible for a taxpayer to establish to the I.R.S. that the creditor institution is not only an agency of the Kuwaiti government charged with investing oil revenues, but that it is also an agency which has as its principal function the maintenance of certain development projects in Kuwait which do not inure to the profit of any individual or any government (beyond the people served).

The taxpayer would probably also have to show that the income earned on these invested funds is not the most significant aspect of the transactions entered into by the Kuwaiti government; this would probably be easier to show if the taxpayer could prove that part of the reason for entering into the transaction (on the part of the Kuwaitis) was to spread out the receipt of certain growth income over a period of years, particularly if the loan agreement provides for certain adjustment features for to take account of changes in currency values and/or changes in values of oil exports.

The Use of Other Companies in the Group of the Borrower

We have considered various plans wherein the lender makes a special accommodation to the borrower. It may be possible for a borrower to receive the loan principal in, and pay the interest from, an affiliated company located in a jurisdiction which itself has a treaty with the creditor's country (or which, for certain reasons of local law, does not present any withholding tax problems at all). If a foreign subsidiary of our borrower were to receive these funds and pay them over to its parent, they could be taxable as dividends to the borrower.38

The Use of Unrelated Banks as Conduits

It is difficult to assess the number of instances in which commercial banks have played a role in transferring funds to and from members of the multinational group. The virtual impossibility of tracking and analyzing these transactions has meant that, in theory, a multinational would be in the position of circumventing the various exchange controls and tax regulations if it were willing to report these transactions in a substantially incorrect manner to the various governmental authorities. But quite apart from this use of a bank as a pure pass-through, there are many instances wherein

a bank may legitimately assume the risks, rights, and responsibilities of two counter-balancing transactions and stand as creditor on the one hand, and debtor on the other. For example, let us assume that our Kuwaiti lender wishes to place $50 million in the U.S. and that he has been unable to take advantage of any other particular plan. It may be possible for the lender to purchase a time certificate of deposit with a financial institution (probably a merchant bank) in the United Kingdom which then would agree to make a substantial loan to the borrower in the United States. If the two transactions are legally, and in reality, two parts of the same whole, then the three parties have effectively worked to avoid U.S. withholding tax on interest payments by an improper use of the jurisdiction. If, on the other hand, the two transactions are legally separate, if the merchant bank advances the funds to the U.S. borrower without a direct security interest being provided in the form of the certificate of deposit, and if the validity of the certificate of deposit to the Kuwaiti lender is not legally dependent upon the repayment of the advance by the bank to the U.S. borrower, then the bank may be said to have effected a real two-transaction deal. In this case, the bank, resident in the United Kingdom, is performing its proper function as the gatherer of funds in an open market and the subsequent placing of those funds to borrowers at a profit. The fact that the placement of the funds and the purchase of the money by the bank are tied in point of time and amount would not appear, per se, to turn the two-transaction deal into a one-transaction deal. It must be remembered that fundamentally every bank is in the position of purchasing money and relending it to customers. Moreover, because of the pricing mechanism of loans made in the Euro-currency market (wherein loans bear interest at a fixed amount above the cost to the lending financial institution), every bank operating in that market can be said to be doing the same type of deal every day. It is only at the point where the bank serves as a mere agent for both Kuwaiti lender and American borrower that the two transactions become suspect. Thus, for a fee, the U.S. withholding tax of 30% on the interest payments which are flowing ultimately to the Kuwaiti lender has been reduced to zero.

Use of Captive Finance Subsidiaries

At various points we have alluded to the use of international finance subsidiaries by U.S. corporate borrowers. These entities were designed specifically to satisfy certain conditions to marketing Euro-bonds in public offerings. Depending on where the proceeds of the placement were to be used, the vehicle was either a domestic corporation ("80-20" company) or a foreign corporation, the latter usually located in the Netherlands Antilles.

The 80-20 subsidiary was employed when most of the proceeds of the borrowing were to be invested abroad. The interest paid by such a corporation is treated by the Internal Revenue Code as foreign source, and thereby exempt from U.S. withholding tax only if less than 20% of this domestic
corporation's gross income comes from United States sources. An addi-
tional prerequisite, that the bond issue be insulated from United States
markets through operation of the interest equalization tax, was satisfied
by qualifying the finance subsidiary under section 4912(b)(3) as one
"formed or availed of" to raise money for a foreign borrower. In practice,
an advance ruling was obtained to this effect from the Internal Revenue
Service (and the applicability of IET noted on the bonds).

In practice, a further requirement was imposed by the I.R.S. that the
finance subsidiary have a debt-to-equity ratio of no more than five to one.
Although the finance subsidiary had no function other than issuing Euro-
bonds and investing the proceeds, it was felt by the Service that it should
have at least some "substance" in order to be treated as a corporate entity
separate from its parent. The 5:1 rule was established through numerous
private rulings as the arbitrary standard to be met. Failing this, the I.R.S.,
in effect, threatened to contend that since the finance subsidiary's bonds
were unconditionally guaranteed by its 100% shareholder, they were in fact
issued by that shareholder (the proceeds being contributed to the capital
of the finance subsidiary). Such a by-pass of the finance subsidiary by the
I.R.S. would have subjected the foreign bondholders to United States with-
holding tax on the interest payments since the parent normally could not
satisfy the 80-20 rule.

When the proceeds were to be invested primarily in the United States,
a Netherlands Antilles (N.A.) finance subsidiary was ordinarily selected
since the combination of the United States-Netherlands Tax Treaty as
extended to the Netherlands Antilles and N.A. tax law provides the
requisite exemptions from withholding tax. Although this route offers
greater flexibility in investing the Euro-bond proceeds (since no source-of-
income requirements have to be met), there are drawbacks. First, in order
to qualify for the withholding tax exemption under the treaty, the finance
subsidiary must obtain a certificate from the N.A. authorities that it is
subject to the full rate of tax in the Netherlands Antilles, and not the
preferential holding company rates. In practice, the N.A. authorities pro-
vide the certificate on the condition that the subsidiary pay full rates of
tax on a deemed annual income of a least 1% of the face amount of the
bonds. The payment of this tax often has increased the effective cost of
financing.

Secondly, the foreign finance subsidiary also is required to maintain at
least a 5:1 ratio. From a practical standpoint, the subsidiary must be
capitalized with cash. As a general rule, the United States parent bor-
borrowed the cash to capitalize the finance subsidiary from a foreign bank, and the subsidiary then deposited the funds under its name with a branch of the same bank.

The finance subsidiary was created not by legislative action, but rather by a complex utilization of existing tax law and treaty provisions, together with tacit Treasury cooperation. Believing that this system resulted in unnecessary cost and administrative effort, the U.S. Treasury became interested in simplifying the foreign borrowing process. Further, from the Treasury's viewpoint, the tax paid to the Netherlands Antilles represented both a loss of tax revenue and a balance of payments drain of at least three to four million dollars annually on approximately $1.2 billion of outstanding N.A. public issues. Finally, the requirement of a 5:1 debt-equity ratio (besides being arbitrary and difficult to justify) has sometimes tied up funds abroad that might otherwise have been kept in or returned to the United States.

The first step toward simplification was to eliminate the necessity of an IET ruling. In addition to being costly and time consuming, this approach proved unsatisfactory where it could be asserted that one of the statutory exclusions from IET should apply to the subsidiary's bonds. The next logical step was to eliminate the need for finance subsidiaries altogether, particularly those located outside the United States. This would end the arbitrary 5:1 debt-equity ratio and the complex corporate structures required to avoid withholding tax on interest payments to bondholders, and would reduce the cost of long-term foreign borrowing.

The IET Extension Act of 1971 contained both the IET election procedure and the necessary amendment to the source-of-income rules. United States corporations and partnerships now could elect to have IET apply either to a new or original debt issue, or to an issue which was already outstanding on April 1, 1971, and which was treated under IRC section 4912(b)(3) as a debt issue of a foreign obligor. Thus, it seemed the clear intent of the Congress to extend the benefit of the new foreign borrowing procedures not only to new issues, but also to issues already outstanding.

The Senate version of the bill added the complementary amendment providing a withholding tax exemption for interest paid on bond issues for which a section 4912(c) election is made. Section 861(a)(1)(g) states that such interest will automatically be considered non-U.S. source (or foreign source) income to the recipient if the obligations (1) when issued (or treated as issued) had a maturity of not more than 15 years and (2) when

44. 26 U.S.C.A. §4912(c) (Rev. 1967).
45. Several conditions were also imposed, i.e., that none of the normal exclusions from IET (including prior American ownership) would apply and that the rate applicable to stock would apply to a U.S. person acquiring the bond. Apparently, both of these conditions were designed to reinforce the barrier against the acquisition by United States persons of Eurobonds.
issued, were "purchased by one or more underwriters with a view to distribution through resale." 46  

As non-U.S. source income, the interest payments to non-resident alien individuals and foreign corporations are, of course, exempt from withholding tax. This exemption applies, however, only to interest attributable to the periods after the date on which the IET election is made. In order to permit elimination of existing finance subsidiaries, the Act provided that the outstanding debt of a finance subsidiary may be assumed by its United States parent, provided the two are members of a controlled group. 47 Since, under section 4912(c)(2), the assumption by the parent corporation was treated as the issuance of a new or original issue, no IET was levied on the assumption. Similarly, no IET was to be levied on an acquisition of outstanding debt issues under a right to convert or exchange a debt obligation of a guarantor, provided the right or guarantee existed at the time the obligation first became subject to an IET election.

An interesting side benefit of the intended simplification of financing was the elimination of the complex and potentially serious question of gain on conversion of Euro-bonds into stock of the parent company. The uncertainties about the proper tax treatment have never been fully resolved, and the possibility still remains that, under certain circumstances, the finance subsidiary could recognize substantial capital gains on conversion.

Certain remaining problems (e.g., exemption of nonresident holders from U.S. estate duty) were eliminated on later legislation. The real difficulty was that the interest equalization tax itself was allowed to expire in 1974 and the Service subsequently refused to issue private rulings on the integrity of captive finance subsidiaries. 48

Given these conditions, it would seem difficult for a prudent advisor to recommend the use of any plan calling for a finance company which is a captive of the borrower.

Debt Placements with Variations

Even if the proposed statutory elimination 49 of the U.S. withholding tax were enacted into law, there would remain a serious problem of that tax in an area which is currently undergoing particularly significant growth: the investment by petroleum exporters in special projects and operating businesses in the United States. The real advantage of placing money outside normal banking channels is not so much ease of administration,
but rather the possibility of earning greater profits. Like many non-U.S. investors holding liquid reserves, petroleum exporters are concerned with problems of inflation and maintenance of earnings over a long period of time. Thus, many potential U.S. borrowers find themselves in the position of trying to offer a loan package to a lender which provides not only for a significant rate of interest, but also certain additional fees, or even a share in the profits of the venture. Since the addition of a legal equity position in a particular venture can change the tax planning to both lender and borrower drastically, it will often be advantageous for both to attempt to structure these additional costs in some form other than equity. The simplest means would be the addition of certain bonus interest costs, initial fees, etc. If these amounts become excessive and if they are dependent upon the earnings by the project before payment is legally required, then all of them (and possibly a portion of the stated interest as well) could be reclassified as dividend payments by the Internal Revenue Service. The consequences to the borrower would be denial of a deduction in computing taxable income in the amount of the payment and potentially different treatment with respect to withholding tax.

Loans with a Real Share in the Profits

It may be much neater to separate the total "fee" to be paid for the borrowing of the money (which fee includes interest, equity, and other fees) by specifying a particular amount of equity in the project to be paid to the lender. For example, a Kuwaiti could lend $50 million for 15 years with no amortization for a period of five years and an option on stock entitled to 10% of the earnings of the venture. The use of an option would substantially shield the investor from sharing in the losses as well as the profits of the particular business. The debt portion of the investment could presumably be run through one of the structures which have been mentioned above; the equity portions may create other problems. If, in fact, the venture does make a profit and is about to pay dividends on its common stock (or on the class of common stock held by the Kuwaitis in the case that there is more than one class), the law may provide a different treatment either for all foreign holders of equity instruments in U.S. corporations, or for all foreign holders of a certain minimal percentage (which would presumably change the classification from "portfolio" investor to "direct" investor in the project). Even if we are able to set up conduit corporations between the Kuwaitis and the U.S. project, there will almost certainly be some form of dividend withholding tax. If, on the other hand, the Kuwaitis had the possibility of letting the earnings accumulate in the corporation and subsequently selling its equity share at a substantial gain, it might have the opportunity to make that gain without any U.S. tax at all as long as its holding of those securities and the subsequent sale were not effectively connected with the conduct of a trade or business within the United States.50

Finally, it frequently may be possible to combine the earning of passive income and the substantial gain through the use of the special advantages through a Netherland Antilles holding company.  

**Loans with Optional Equity**

The implementation of an optional equity feature may also be effected with the use of warrants for existing stock or the issuance of convertible debt obligations. Each of these provides a number of additional planning opportunities, but a number of problems as well. In the case of convertible debentures, for example, the most likely type would be a debt instrument convertible not into shares of the U.S. subsidiary operating a particular project, but to the common stock of the U.S. parent which is the real borrower. The myriad of unanswered tax questions resulting from this type of convertible debt placement would, in and of itself, make this an undesirable option.

**Analysis of Business Conditions: Timing Problem**

At the outset, both investor and borrower must satisfy themselves that the payment of passive income, the timely repayment of principal, and the appreciation of the various equity interests in the venture are commensurate with the risks taken. A number of ventures throw off no cash for several years; this raises the possibility of a borrower obtaining substantial advantage under an agreement whereby he pays a higher effective interest rate but enjoys a holiday from interest and principal repayments for that initial period.

In addition, we have not considered the types of variations that may be present where the project is a true joint business venture. Such may be the case when dealing with a particularly large construction project, especially one related to the petroleum business. A U.S. borrower, setting up a business which would provide significant export to the home country of the investor, may call on sources of money from that country. In these circumstances, it may be appropriate to experiment with separate classes of stock, preferred and common stock, etc. From the point of view of both parties, the capital structure should provide the adequate cash flow for the business, should provide the cash investor with a reasonably transferable and marketable share of the project, and should provide the U.S. corporation with sufficient protection against his capital sources of drying up.

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52. For a detailed analysis, see Mentz and others, A Report on International Finance Subsidies, 28 Tax L. Rev. 443 (1973).
In addition to the above, the prudent advisor would consider the effects of any exchange gain or loss to the borrower. Furthermore, any separately-incorporated project which is itself the borrower may be subject to attack on the grounds that it is thinly capitalized.

III. Conclusion

At this writing, the possibility of unilateral tax amendment by the United States still exists. Even if not acted on during the year 1976, this measure is certain to be considered in subsequent sessions of Congress. As noted above, the role of international banks in serving as vehicles for these loan transactions may increase dramatically.

Barring these developments, however, the advisor faced with the need to create a structure at this time must deal with a number of issues which remain unresolved and cannot offer his client a transaction eliminating all significant risk.