UNIVERSITY OF LONDON

THE DILEMMA OF INTERNATIONAL TAX ARBITRAGE: A COMPARATIVE ANALYSIS USING THE CASES OF HYBRID FINANCIAL INSTRUMENTS AND CROSS-BORDER LEASING

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A THESIS SUBMITTED TO THE DEPARTMENT OF LAW
OF THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE
FOR THE DEGREE OF

DOCTOR OF PHILOSOPHY

LONDON, UK.
2005

Abstract

My thesis addresses the question of International Tax Arbitrage ("ITA"). The discussion is comparative in nature, covering the United States and the United Kingdom. The study builds a foundation to discuss cross-border transactions where the laws of more than one jurisdiction apply to the transaction in question. Weighing the intervention of national revenue authorities in these transactions requires us to look also at the different background and policy objectives of each country, including the varying tax incentives that exist in each jurisdiction and the attitude of each country towards cross-border transactions.

ITA is a situation whereby a given taxpayer structures her affairs in a way that allows her to follow and comply with the tax laws of two or more jurisdictions while receiving a tax advantage without any net investment as a result of inherent inconsistencies between the tax laws of the different jurisdictions, thus reducing her overall world tax rate.

I focus on the question whether taxpayers should be allowed to exploit inherent differences between the tax rules of different jurisdictions. I discuss this question both at the practical level and at the policy level.

To properly answer this important question, we need first to determine what are the relevant policy considerations that should be taken into account. In this analysis, attention has to be given also to considerations that are not always included in the analysis, like foreign policy and political considerations, including in the UK, the impact of EC law on tax policy.

Once the considerations have been identified, it is necessary to apply them to the situation at hand. In the thesis, I explore the different considerations both independently and in relation to specific case studies and develop an approach to analyze the appropriateness of ITA in given situations.

Acknowledgements

A few years ago, while I was working at Ernst & Young I realized that I wanted to write a dissertation. Some time later, I came across an article by H. David Rosenbloom on International Tax Arbitrage. I found it stimulating and I could really relate to it because arbitrage formed part of my practice. A year after that, I moved to the UK, came to the LSE and registered as a PhD student and started my journey.

All this would not have been possible without the help of my supervisor, Dr. Ian Roxan, who managed to challenge me intellectually in ways I had not anticipated. His vast knowledge and intellect made every meeting a challenge that I really enjoyed. Our discussions were inspirational and covered many different subjects, even the proper use of the English language, an area that I as a foreigner found very interesting and challenging.

I am indebted to Professor Philip Baker, an inspirational lecturer and a person of many skills who allowed me to participate in his classes on international tax law and EC tax law and who treated me as if I was his student. His knowledge, wisdom and advice have been invaluable.

I would like to thank Professor John Avery Jones and the trustees of the Avery Jones Award and the LSE Research Studentship fund for their generous support in my project throughout the period. In addition, I would like to thank IFA for inviting me to present my thesis as a poster during the 2003 congress in Sydney, to IFA London Congress Trust and LSE for their support in financing the trip to Sydney and to the IBFD for inviting me to participate in their second annual PhD in tax students meeting in Amsterdam.

I would also like to thank Professor Michael Lang and the members of the Austrian and International Tax Institute in Vienna for giving me the opportunity to participate as a Marie Curie Fellow in International Taxation. During my stay in Vienna I was fortunate to work with Professor Lang and with his colleague Judith Herdin on the general report to the 2004 IFA Congress in Vienna.

I would also like to thank my good friend and colleague, Yariv Brauner, for his suggestions and advice regarding my research in US tax law and to George Pitsilis for the discussions on EC tax law.

A special thanks also goes to my old professor and friend, Professor Mike Oberst from the University of Florida, who gave me the tools to read, interpret and understand US tax law and inspired me with his dedication and love of teaching.

All this would not have been possible without the support and love of my friends and family. I would just mention Tamar who has been by me throughout the process, and my family - my sister, my grandmother and above all, my dear parents to whom this work is dedicated. Without them there would be nothing.

In the First Book of the Kings we are told about the story of Saul who went to search for his father's asses and found kingship. During my journey I have discovered that it is all about the search and less about what we eventually find. Thanks to those I mentioned above, I had a very interesting and challenging journey.

London, UK
April 2004

Naturally I take responsibility for any remaining errors. For consistency, I have used US spelling throughout, except in quotes from sources using British spelling.

"Everything is economics but economics is not everything."

Paul Krugman

Chapter 1 - The Dilemma in its Legal Context

The Hypothesis

The hypothesis I shall use for this chapter and for the thesis in general is a two-fold hypothesis that was presented by Rosenbloom as follows:[1]

"International tax arbitrage is the natural response of taxpayers to the normal differences that occur between any two tax systems. As such, it does not represent a problem, or at least no adequate explanation for why it is a problem has yet been given, other than invoking an "international tax system" that does not exist. Moreover, even if international tax arbitrage were a problem, in the current and any reasonably likely future of the world, no solution is likely to be available. Therefore, tax policymakers should not bother to try to combat international tax arbitrage, and should repeal those provisions (such as the dual consolidated loss rules) that are inspired by the desire to prevent it."[2]

The starting point is that there are differences between the different tax systems, differences that are to a large extent, the result of the different background, policies and development of each of these tax systems. For many years these systems evolved separately without any connection between one and the other. To a large extent these systems are based on different sets of principles and policies. Even when some of these principles and concepts may share the same name, often their applications may nevertheless be completely different in each jurisdiction. In addition, since different tax systems are to a large extent based upon and interpreted by different sets of legal and interpretation rules, different attitudes are adopted in different countries with respect to questions of tax avoidance, tax mitigation and statutory interpretation. As a result, similar transactions may be treated completely differently by different jurisdictions.[3]

The rapid changes in the world's economy challenge many of the existing concepts of taxation in general and of international taxation in particular. As a result of the growth in international trade and commerce, the deregulation of many of the existing local markets and the globalization of the financial markets, trade and commerce become global issues regardless of whether the different tax systems are able to deal with such development.[4]

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[1] As summarized by Avi-Yonah (1999-2000) who commented on Rosenbloom's article (1999-2000) on the issue.
[2] Avi-Yonah (1999-2000).
[3] I explain this point further in the case studies below.
[4] Roxan (2003b).

The outcome of such development is an ever-increasing interaction between different tax systems in ways that were not perceived until now. The existing concepts or policies are no longer able to deal successfully with many of the issues that resulted from such development. Some of the problems are new problems but most of them are merely a development of existing problems.

The result can be either single, double, triple or no taxation of the same income. This outcome can be achieved either intentionally, in cases where the taxpayer is planning her affairs in a way that will ensure non-taxation of the income, or unintentionally, in cases where the tax outcome is just the normal consequence of the business transaction or activity that took place. ITA, for that purpose, is one of several possible outcomes. Its uniqueness is in the fact that the benefit is obtained from the difference between the tax systems.

In this work, I intend to examine the features of ITA and it appropriateness as a "side effect" of the unfinished process of globalization which we are in the midst of.

Working assumptions

For the purpose of the discussion I shall make certain assumptions to narrow the scope of the discussion to the more interesting elements of ITA. First, while it is possible that ITA will result in double and even triple taxation that in certain cases may not be relieved through the use of the existing tax relief mechanisms, the discussion below is focused on the other side of the coin. That is, ITA that results in double non-taxation or in some other tax advantage, as opposed to a tax disadvantage.

Second, while certain ITA situations are the result of inadvertent or unintentional operations, the ITA that I shall focus on in this thesis is ITA that is obtained intentionally (or if to be more blunt – deliberately) by the taxpayers in order to achieve the desired tax advantage. This, however, does not mean that the taxpayer has no other business reason in structuring the transaction.

The Case studies

The aim of this paper is not only to look at the immediate question of ITA but also to examine existing policy considerations through the use of ITA. To make the discussion more focused I chose to use two case studies that illustrate the dilemma of ITA and to relate the discussion to two jurisdictions, the US and the UK. In addition to the general discussion of the case studies in the context of both jurisdictions, in each jurisdiction I examine an additional issue through the lens of ITA: the use of political considerations as part of the tax policy discussion in the US and the relations between EU and the UK.

Case Study 1 – Hybrid Financial Instruments (HFIs)

Company X, a resident of country X wishes to expand its operations into country Y. for that purpose, it incorporates a wholly owned subsidiary, company Y. To finance the subsidiary's operations, company X transfers $500,000 to company Y in exchange for HFIs that are issued by company Y. Due to differences in the taxation of HFIs in country X and in country Y, the HFIs issued by company Y are classified as debt for country Y tax purposes and as equity for country X tax purposes. As a result, payments made on the HFIs are treated as dividend in country X and as interest in country Y enabling company Y to claim interest deductions with respect to these payments. At the same time, these payments are not subject to tax at the hands of company X.

Case Study 2 – Double-dip Cross-border Leasing

Airplane Inc. an airplane manufacturer resident in country X enters into a lease with EasyAir, a country Y airline company for the lease of an airplane. Due to differences in the tax laws of both countries, both Airplane and EasyAir both are regarded as the owner of the leased airplane for tax purposes and each is entitled to receive depreciation deductions.

The Analysis

In this thesis I wish to explore the dilemma of ITA through an analysis of two case studies, HFIs and cross-border leasing. The starting point for my discussion is to explore the different arguments and considerations that are used or should be used in the process of evaluating whether ITA represent a problem that warrants intervention.

This discussion begins with examining ITA vis-à-vis statutory interpretation. This is followed by an analysis of international law with the purpose of determining to what extent it can be argued that there is a principle of international law that requires tax to be imposed once (the single tax principle). To the extent this argument is valid, then the single tax principle is a valid justification for intervention in ITA situations. Otherwise, whether or not to intervene is still a question that is subject to the full discretion of each country applying its tax legislation to further its tax policy goals.

At this time I move to discuss the more traditional considerations used in the limited ITA discussion. These are efficiency, neutrality, equity and competitiveness. The aim is not only to explore their application to ITA but also to define them and their scope in light of recent literature. This is especially with respect to neutrality and efficiency as they both are reflected in Graetz recent critique[5] and the consideration of competitiveness that is often used but seldom explained.

This is followed by an analysis of other considerations that are mentioned in the context of ITA. These considerations include harmful tax competition and its possible resemblance with ITA, revenue loss and the argument that ITA is an unintended result and thus countries should be more willing to cooperate in objecting to ITA than in other areas.

In the next chapter I move to discuss those considerations that are not always referred to in policy discussion but I believe them to represent an important part of the discussion. I refer to them as the practical considerations and they include foreign policy, political considerations and implementation.

Following the chapters in which I discuss and explore the possible considerations at a more general level, I move to discuss the case studies where the different considerations are to apply to deal with two specific situations, ITA in HFIs and in cross-border leasing.

First, I present the legal context of each system and my focus in the analysis. In the UK, the focus is not on the UK tax policy per se but rather on the impact EC law has on this policy. As I argue below, I believe that the interaction between existing EC law limitations in direct tax matter on one hand and ITA on the other hand lead to some interesting questions which I intend to explore.

While in the UK context I focus on the interaction with EC law, in examining the US I focus on the political considerations that are at the center of the debate. By reviewing the development of tax policy especially from the time of the important compromise of 1962, I explore the limitations of such compromise and the current state in which the US is at and its relevance to the question of ITA.

At this time I move to discuss the case studies, starting with HFIs which I believe to be the more general case study and then the more specific case of cross-border leasing. In each case

[5] Graetz (2001).

study I carefully examine the general methods that exist for the taxation of HFIs and cross-border leasing, respectively, moving to explore the method in which each system is approaching these issues and finishing by an analysis of cross-border limitations imposed in each system and their possible application to ITA, either as limitations on its existence or as an indication as to whether or not it should exist based on the country's overall tax policy.

In doing so, I intend to establish a few points. First, the distinction that gives rise to ITA is not between an economic substance approach and a legal form approach but rather a more delicate distinction with more limitations on the availability of ITA than originally believed.

Second, I intend to argue that each system develops as an independent system reacting mainly to domestic tax planning and developing to a large extent without regard to their international tax implications. As a result, attempts to create more coherent distinction domestically may lead to the creation of new ITA opportunities at the cross-border level.

Third, examination of the cross-border provisions in general may prove as an effective tool in discussion of ITA.

In the next chapter I return to the policy level. After summarizing the limited writing on ITA together with introducing some of my conclusions from the analysis thus far, I move to apply the different considerations discussed earlier in the thesis to possible situations that exist in the two chosen case studies, thus exploring different considerations with respect to specific situations.

The final chapter concludes.

Appropriateness and the coherence of the system

This argument stems from Rosenbloom's criticism that basically poses a rather naïve question of what can be wrong if the taxpayer is complying with the laws of the two systems involved.[6]

Basically, according to the above-mentioned definition of ITA, in each jurisdiction the taxpayer satisfies all the tax laws requirements in that jurisdiction and as such should be entitled to receive the associated tax attributes. The taxpayer is consistent in her presentation of the facts in both jurisdictions and the mere advantage received is the result of the inherent differences between the tax systems, differences that do not and should not render void or alter the treatment received in each jurisdiction.

It is, however, important to understand what is meant by this requirement in order to fully appreciate the definition and dilemma of ITA. Prima facie, it is clear that at least as far as the statutes are concerned, the taxpayer satisfies the requirements necessary to obtain his desired tax treatment in each jurisdiction. For example, in the case of a HFI (that is further discussed below in chapter 6) the taxpayer satisfies the legal requirements necessary to allow for an interest deduction. The questions that should be asked at this stage are: (1) is there an inherent requirement in the statute that would disallow the interest deduction even if all the formal requirements were met?
(2) should the court, in analyzing the statutory meaning, look into the tax treatment of the instrument in the other jurisdiction?

To a large extent, this is a question of statutory interpretation that may vary from one country to another. If the country in question follows a tradition of purposive interpretation, then the purpose of the statutory provision might lead to the existence of an implied reliance on the treatment in the other country. Conversely, a textual approach to statutory interpretation can lead to the opposite conclusion by limiting the inquiry to the conditions specifically provided for in the statutory instrument.[7]

Cases of tax avoidance depend on the approach to statutory interpretation.[8] As Likhovski rightly notes in his historical analysis of anti-avoidance decisions in both the US and the UK,

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[6] Rosenbloom (1999-2000).
[7] West (1996).
[8] Likhovski (2004). For example: *Gregory v. Helvering* 293 US 465 (1935) and *MacNiven v. Westmoreland Investments Ltd.* [2003] 1 AC 311 (HL).

there are more than mere legal reasons that lead judges to arrive at a certain decision. Thus, in addition to possible legal differences that may exist between one system to another, it is also necessary to take into account other non-legal factors as this might have an impact of the way statutes are interpreted in different jurisdictions and thus on the availability or unavailability of ITA.[9]

Once the appropriate approach to statutory interpretation is selected, it is necessary to examine the focus of the analysis. In ITA, the benefit is only visible if the entire transaction is looked at from all the relevant jurisdictions' perspectives, and not only from the perspective of one taxpayer in isolation. The role of foreign tax law is an active role in the formulation of the benefit.

In contrast, in most cases of tax avoidance, foreign tax law does not have an active role in determining the benefits derived from the transaction. In addition, the foreign participants are usually involved because they are indifferent with respect to the outcome of the transaction and in some cases they are replaced by other taxpayers who are in an indifferent position (for example, tax-exempt entities, loss corporations etc.). For this reason, the courts, in examining cases of tax avoidance, generally focus on the application of the law in one country, not taking into account the treatment in the other country.[10]

In addition, most tax avoidance cases usually involve some type of artificiality[11] that allows the taxpayer to gain the extra benefit. In ITA, the artificiality is not necessary because the benefit is achieved through the inconsistency in the treatment in the two tax jurisdictions.

[9] Among the non-legal reasons mentioned by Lihovski are: cultural reasons surrounding the morality of tax avoidance and political context that exists at the time of the decision. In addition, mention is made to the background of the judges, their education and practical experience etc. see generally, Likhovski (2004) at 24

[10] For example, see the decisions in *Compaq Computer Corp. and Subsidiaries v. C.I.R.* 277 F.3d 778 (CA 5th Cir (2001)). and *IES Industries, Inc. v. US* 349 F.3d 574 (CA 8th Cir.(2003)) (where the real issue was whether the taxpayer is entitled to enjoy the benefit of the foreign tax credit. The tax treatment under foreign law was irrelevant. The only relevant part was that it resulted in foreign tax credit that the taxpayer sought to claim. A better approach to the issue dealt with in these cases would be from an ownership perspective, asking whether the US taxpayer actually own the ADRs to be able to claim the benefits of the foreign tax credit (see generally, Kingson (2001)). Similarly, in *Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925 (Tax Ct. 1972), the focus was on whether the foreign taxpayer "received" the income in the way required under US domestic law and the applicable treaty. Whether the foreign taxpayer was taxed was irrelevant for this purpose. This approach is also consistent with *TAM 9748005* where the IRS supported a characterization of a transaction as a lease even though the other taxpayer (the lessee) claimed and received an inconsistent characterization under his own laws. The treatment under foreign law was determined to be irrelevant. In the UK, the general approach in statutory interpretation appears to be similar and to focus only on the tax treatment of the resident taxpayer. For example, *McGuckian v. IRC* (1997) 3 All E.R. 817, *Barclays Mercantile Business Finance (BMBF) v. Mawson* [2003] EWCA CIV 1560 (8) and in *BMBF (No. 24) Ltd v. IRC* [2002] STC 1450.

[11] In this work I use the term artificiality as being similar to the requirement of business purpose. Artificiality exists where an act has no independent rationale apart for the tax reduction rationale. For example, the use of an intermediary for no reason but for a tax reason. For a discussion of the business purpose – see generally, McMahon (2002).

Example

A good example to illustrate the difference is a comparison between double-dip leasing and a sale-leaseback transaction. Under a double-dip leasing, as described above as case study 2, the benefit, which is essentially a timing benefit, is achieved through the interaction between the two tax systems which results in both the lessor and the lessee being regarded as the owners of the leased equipment entitled to receive depreciation deductions. Whereas under a regular single-dip lease, there are two sets of deductions one depreciation deductions at an accelerated pace and another rental deductions at a regular pace, a double-dip lease provides instead for two accelerated depreciation deductions (and no rental deductions). There is no added artificiality in the transaction because the transaction is identical in its structure to a regular single-dip leasing transaction.[12]

In a sale-leaseback, an asset that is owned by taxpayer A is sold to taxpayer B who then leases it back to taxpayer A. From an economic perspective and from a practical perspective, the transaction has not changed anything. The asset never left taxpayer B's possession who continues to use it as before. The only difference is legal with tax implication. That is, the ownership passed to taxpayer B. In fact, the transaction is very much like a loan from taxpayer B to taxpayer A, the sale price is regarded as the loan and the rental payments as the repayments on the loan. However, unlike a regular loan, here an additional advantage exists in the form of the depreciation deductions that taxpayer B may claim with respect to the property, deductions that are generated as a result of a purely financial transaction.

The transaction represents an artificial creation of depreciation deductions with respect to a property that is already depreciated in full or in part usually by the same tax system. The depreciation deductions are essential for the transaction to be commercially viable and are the product of the artificial sale-leaseback.[13]

To summarize, the questions to ask in applying tax law to determine whether the tax treatment is the appropriate treatment is the following: in applying the relevant approach to the situation is there an implied or an express intention by the legislator that the benefits received in the jurisdiction are contingent upon the tax treatment in the other jurisdiction? In the absence of such intention, the focus of the analysis should be on the taxation in the

[12] Arguably, the basic concept of a lease is an artificial concept that allows one taxpayer to transfer tax attributes to another taxpayer. However, unlike the artificiality element in a tax avoidance scheme, in a lease the artificiality is accepted and encouraged by the tax system.

[13] Recently, the Inland Revenue commented on the artificiality element of sale-leaseback transactions in REV BN 29, 17 March 2004.

country whose laws are being analyzed, no more no less.[14] While the adoption of purposive interpretation might prove to be wider and allow intervention also in situations where the plain text does not provide reliance on the treatment under foreign law, it is still necessary to establish the existence of an intention to be able to rely on the treatment under foreign tax law. As West notes, such reliance usually does not exist.[15]

[14] See generally, West (1996).

[15] West (1996) and see further discussion below (for example, pp. 196-197).

International Law

The starting point for the entire discussion is the legal framework in which tax law exists. As countries operate within a framework of international rules and principles, it is necessary to examine not only the single country legislation but also the potential effect, if any, international law might have on the tax treatment of a taxpayer/transaction. This is especially true when the transaction in question is of an international nature, in which case, it is more likely to give rise to international law issues.

At the international level, international tax law is very much a part of international law. In international tax like in international law, the relevant countries have to establish their jurisdiction before they can impose taxation on the income. Once jurisdiction has been established, countries usually exercise their sovereignty to determine how and to what extent the income that is subject to that jurisdiction should be taxed. This exercise of sovereignty is usually limited by the acceptance by a country of international law principles.

"Sovereignty refers to the bundle of rights and competences which go to make up the Nation State. Jurisdiction refers to particular rights from that bundle, namely a State's right of regulation. States do not have absolute and unfettered rights of sovereignty and jurisdiction. The nature and extent of a State's sovereign rights are determined by:

its own internal constitutional arrangements – the internal dimension of Sovereignty; and most importantly for the purposes of this study, by the interaction of international law (in particular custom, treaties and supra-national entities such as the EC) with national law – the external dimension of sovereignty."[16]

The two main limitations that exist are treaties and customary international law (CIL).[17]

Treaties represent an important limitation on the countries' ability to exercise their jurisdiction, a limitation countries take upon themselves voluntarily either through bilateral treaties or multilateral treaties. This type of limitation is restricted, however, to the limitations imposed by the treaty and applies only to the extent that the relevant country is a party to the treaty and only with respect to taxes covered by the treaty in question. Such limitation might also be conditioned on the existence of certain requirements that the

[16] Jeffery (1999) at 170.
[17] Shaw (2001) chapter 3. The interaction with EC law in the context of the UK is discussed separately below (pp. 81-95, 242-245).

taxpayer would have to satisfy in order to benefit from the treaty. In the tax area, most of the treaties are bilateral by nature and to a large extent they follow one of two leading models, the OECD model tax convention and the UN model tax convention. A treaty, however, does not have to be a tax treaty to limit the exercise of sovereignty in tax matters. A good example for that is the EC Treaty.

The second important source of international law is CIL. Unlike treaties it can be more uncertain in its existence and scope and applies with respect to all countries except to those that expressly protested against its adoption in the first place.[18]

Avi-Yonah argues that to the extent CIL exists in the international tax context (and he believes that it does), it is possible to argue that there is an international tax regime and to that extent, there is a legitimate objection to ITA.[19]

Looking at the definition of CIL, two cumulative requirements emerge. First, the rule has to be subject to a general and consistent practice of the states. Second, such practice has to be followed by the states due to a belief of a legal duty or an obligation (*Opinio Juris*).[20]

The first requirement deals with the existence of state practice. The exact definition of what constitutes state practice appears to be inconclusive. Thus, there is some disagreement regarding the exact scope of what constitutes evidence of state practice and whether only positive acts of a state qualify as state practice or also other statements *in abstracto*.[21] Similarly, there is no consensus of the amount of acts, the length of time, number of countries taking part in the practice, and number of repetitions that are necessary to establish state practice. For example, on one hand, the International Court of Justice held that a practice that lasted for more than 125 years gave rise to CIL and on the other hand, the establishment of CIL in outer space was very quick.[22]

A better approach appears to be one, which is dependant on the specific facts and circumstances of the relevant custom that is sought to be established and the length of time, number of countries involved, number of repetitions and other elements establishing the

[18] CIL has a universal application and would apply to all countries regardless of their involvement in the process of establishing the specific CIL. This would apply also to countries who object to the rule after its acceptance but not to those who objected to it from the very beginning. See generally, Akehurst(1974-5).
[19] Avi-Yonah (2004).
[20] See generally, Akehurst (1974-5), D'Amato (1971), Brownlie (2003) at 6-12 and Statute of the International Court of Justice, Art. 38.1(b).
[21] Compare, for example, Akehurst (1974-5) at 1-11 with D'Amato (1971) at 88.
[22] Shaw (2001) Chapter 3.

existence of state practice would tend to vary depending on the situation in question.[23] For example, it is generally more difficult to create a rule of CIL which departs from existing CIL as opposed to one which operates in vacuum and stronger evidence would be required to establish the rule in the former situation.[24]

In addition, in general, the practice has to be consistent and the existence of inconsistency both in state practice and among the different countries involved can require other elements to be more persuasive for the rule to qualify as a CIL.[25] Akehusrt suggests that the way to approach inconsistencies and conflicting interests that cannot be resolved based on time difference (earlier and later practice) or some other relatively objective criteria is by looking at it in relative terms, similar to the approach with respect to acquisition of title in international law. That is, the one who has a better claim prevails.[26]

Even if the first requirement is met, it is necessary to establish that the countries following this practice do so out of a sense of a legal obligation. For that purpose, it is necessary to not only to establish that there is a legal obligation to follow the practice but also that the states following it do so knowing that such obligation exists.[27]

This requirement suffers from an internal difficulty in the creation of new CIL as it requires countries to act under the belief that they act because they are obligated to do so although the obligation itself (the new rule of CIL) is still not formed and therefore there is no obligation at the time the act is performed.[28] Nonetheless, the majority view appears to be that *opinio juris* is required in the establishment of a rule of CIL and for distinguishing CIL from general state practice.

Otherwise, many principles that exist in general state practice might be wrongly classified as CIL with all the important consequences such classification has, including the binding effect CIL has on countries that did not object to the rule becoming CIL who are later bound by its application.[29]

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[23] See generally, Akehurst (1974-5) at 15-16 (time), 16-18 (number of states), and 18-19 (different presumption that exist).
[24] *Ibid.*
[25] Akehurst (1974-5) at 20-31 dealing with the different aspects of consistency of practice. In addition, the consistency of practice (or lack thereof) can have an impact on the strength of the rule once it becomes CIL.
[26] Akehurst (1974-5).
[27] Akerurst (1974-5).
[28] This difficulty led to different interpretations and some suggestions with respect to this requirement of *opinio juris*. See generally, Akehurst (1974-5) at 32-34). See also the Statute of the International Court of Justice Art. 38.1(b) that requires "international custom, *as evidence of a general practice accepted as law.*" (Emphasis added).
[29] However, those countries that object from the beginning before the rule became part of CIL are allowed to disregard it. See generally the *Anglo-Norwegian Fisheries* case (ICJ Reports, 1951, at 116; 18 ILR, at 86).

Even if CIL exists in the tax context as Avi-Yonah argues, it is still necessary to establish the content of that CIL and what exactly it means. For Avi-Yonah, it appears to include what he refers to as the Single Tax Principle, the requirement that income should be taxed once, no more no less. If it does, then arguably, there is a legitimate justification to object to the existence of ITA. Thus, I shall limit the discussion in the following paragraphs only to the issue at stake.

Most of existing CIL in international tax are in the context of tax treaties. For example, the basic rules determining tax treaty interpretation originates from the Vienna Convention on the Law of Treaties, which is applicable also to the interpretation of tax treaties and is regarded as a codification of customary law thus applicable not only to those who are party to the treaty.[30]

In the context of Avi-Yonah's argument, arguing for the existence of a single tax principle to exist at the international level, there has to be either a positive limitation in existing treaties or a rule of CIL that would apply even in the absence of a positive requirement in the treaties or even if the taxpayer does not apply to a treaty.

To establish such a rule of CIL, it is necessary to prove the existence of the following conditions: first, the single tax principle should exist in state practice of different countries and this state practice has to be consistent and repetitive enough to qualify as state practice for CIL purposes. If we follow Akehurst wide definition of state practice, such state practice can be evidenced also through treaties to which the country is party and statements made in that context by state officials. It is, however, important to establish a consistent approach. Second, in applying this state practice, it is necessary to establish that the state practice was carried out under the knowledge by the state that it is obligated to do so. Otherwise, the necessary *opinio juris* would not be met.

Let us briefly analyze each of these requirements. First, the requirement of state practice that would appear to follow the single tax principle does not appear to exist in the meaning required by CIL. *Prima facie*, countries that tax on a worldwide basis while granting a foreign tax credit, as a relief from double taxation would appear to follow this principle. However, it is still necessary to establish that the reason for such conduct is based on the single tax principle and not just a rule of convenience or indifference and that this rule is

[30] See generally, Sinclair et al. (1986).

applied consistently and repeatedly throughout a certain period. Such evidence can come, for example, from official statements relating the application of tax treaties to which the country is a party. In addition, it is not sufficient to establish this principle with respect to one country but to a large number of countries, mainly due to the generality of the principle and its central role, if accepted as CIL, in taxation of cross-border income in general and in tax treaty interpretation in particular.

Even if we look at the narrow area of tax treaties, it appears that there is no consensus among countries with respect to the existence of the single tax principle. This can be ascertained from a recent comparative study of the issue of double non-taxation in the application of tax treaties.

Double taxation, for example, has been thoroughly discussed in international tax law. From existing tax treaties, country practice, and international model conventions, it is quite clear that the prevention of double taxation can probably be regarded as the above-mentioned state practice requirement. Indeed, this principle is also reflected, in one way or another, in domestic legislation of most jurisdictions.

The same cannot be said of the prevention of ITA or of double non-taxation. The above-mentioned examination of the state of international law and practice in the context of double non-taxation establishes that unlike the prevention of double taxation, this principle does not exist in tax treaties on a regular basis and can hardly be said to be part of existing customary law.[31] Only in 1999, the OECD has introduced the prevention of double non-taxation and for the first time attempted to add to the Commentaries the principle that tax treaties are also applied for the purpose of the prevention of double non-taxation.[32]

Current practice and application of tax treaties lead to conflicting positions. On one hand, it is established both in practice and academic writing, as well as in case law, that application of a tax treaty may lead to double non-taxation of a transaction/taxpayer due to an inconsistent treatment of the transaction/taxpayer under the laws of the two countries involved.[33] This view is in line with existing practice of the treatment of foreign income for domestic tax purposes, at least in the two jurisdictions examined in this work. In both situations, foreign law (and not tax law) is used to establish the legal character of the

[31] *Crown Forest Industries Ltd. v. The Queen*, [1995] 2 C.T.C. 64, 95 D.T.C. 5389, 125 D.L.R. (4th) 485, [1995] 2 S.C.R. 802 and *Hausmann Estate v. The Queen*, [1998] 4 C.T.C. 2232 (both decisions support the view that the prevention of double non-taxation is not part of the object and purpose of tax treaties).
[32] OECD (1999). Cf. Lang (2000).
[33] See generally, Lang (2004); Avery Jones et al (1996) and Avery Jones et al (1999); *Memec plc v. IRC* [1998] STC 754.

transaction, a result that is applied to domestic tax law principles for the determination of the tax treatment in the country.[34]

On the other hand, some countries have adopted over the years, as part of their double tax treaties policy, measures that are meant to prevent double non-taxation and in recent years the OECD made certain changes to the existing model treaty. These measures and changes, however, are aimed mostly at preventing double non-taxation as a result of mismatch in the tax jurisdiction of the two countries involved, a mismatch that results from the application of the treaty. Such measures are not aimed at, or attempt to prevent ITA, although it might be argued that they are a step in establishing the single tax principle as a basic principle of international tax law.

A better view of these measures is to regard them, to the extent they are incorporated into the treaty, as constituting a specific rule to deal with specific situations and not a general practice to serve as an underlying principle. It is possible, however, that with the development of a consistent policy both the OECD and UN model tax conventions and specific countries, things might change.

Even if it were possible to establish a general state practice exists, it is still necessary to establish that the different countries follow this policy with the knowledge that they are legally obligated to do so. That is, to establish the existence of *opinio juris*. Otherwise, the state practice would probably not be regarded as forming CIL.

Although the existence of many different bilateral treaties following the same manner can theoretically lead to the creation of CIL, caution is warranted in this respect.[35] Thus, it should be noted that even the prevention of double taxation, which is at the center of tax treaties and represents the underlying principle for entering into tax treaties probably does not exist independently of a treaty and thus does not form part of CIL. If this is the analysis with respect to the prevention of double taxation, then it should follow that the prevention of double non-taxation, whose existence as a general principle in the context of tax treaties is still debatable, is even further from qualifying as a principle of CIL.

At present, subject to certain limitations of international law, taxation is to a large extent, a domestic issue, determined at the domestic level and based on domestic considerations.

[34] In the UK, see generally *Rae v. Lazard Investment* (1963) 4 TC 1, *Baker v. Archer-Shee* [1927] AC 844 and *Archer-Shee v. Garland* [1931] AC 212. In the US, see generally the discussion in West (1996).
[35] Brownlie (2003), *ibid.*

Countries are generally unwilling to relinquish their sovereignty, even though such act might lead them to be better off. As it is further discussed below,[36] even in the limited context of the EU, member states (MS) are reluctant to relinquish their sovereignty in tax matters.

[36] See pp. 81-95 and 242-245 below.

Chapter 2 – The Traditional Arguments

The Efficiency Debate

In the previous chapter I discussed ITA in its legal context and established that at present, subject to certain limitations of international law, taxation is to a large extent, a domestic issue, determined at the domestic level and based on domestic considerations. In the next few chapters, I examine and analyze the different considerations that countries use in determining their international tax policy, with particular reference to ITA.

A few basic concepts

Our starting point in the tax policy discussion is efficiency. The question before us is whether and to what extent efficiency can be used as policy objection to ITA. Before dealing with this question, let us define some basic concepts that we shall use in the analysis.

Tax efficiency is based on the idea that available resources should be used in a way that would result in maximum welfare. A Pareto-optimum is achieved when a market has reached a situation whereby any further improvement in the position of some of the participants results in deterioration in the position of the other participants.[37] In practice, this is modified by the requirement of no net gain in the market. That is, there is no further gain without an offsetting loss. For that purpose, a net gain change is defined as a situation whereby if we examine the changes of all the participants in the market, the amount of gain allocated to some taxpayers exceeds the amount of loss suffered by others. In other words, this deterioration cannot be compensated by the improvement in position of the former group of participants.[38]

The two fundamental theorems of welfare economics are that every competitive economy is Pareto efficient and that every Pareto efficient resources allocation can be achieved through a competitive market mechanism.[39] Pareto-optimum does not tell us anything on the other values of the resource allocation apart from efficiency and that there can be no further gain without a corresponding loss.

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[37] James and Nobes (2000) at 22.

[38] *Ibid.* "No net gain" is probably a simplistic way of defining the situation, mainly because in many cases, it is unclear how to compensate the losing party for its loss and thus it is hard to conclude whether overall there is a net gain or not.

[39] Stiglitz (2000) at 60.

Thus, having reached a Pareto-optimum does not necessarily mean that this state cannot replace it with another Pareto-optimum, which better addresses other policy goals, as for example, one, which adopts better redistribution mechanisms.[40]

Tanzi, discussing taxation in a global world, identified two patterns in investments and taxation. He found that direct investment is affected by the level of effective tax rate whereas portfolio investment is usually affected by the tax rates.[41]

According to Tanzi, in light of the globalization process and due to the existence of competition, countries are likely to pay a higher price than in the past if they impose high marginal rates with respect to these types of income. Because the allocation of the world's capital is likely to be influenced (if not driven) by tax considerations and not only the pre-tax return on investment, greater inefficiencies in the allocation of this capital may result. The immediate types of income at stake are the more mobile income such as highly skilled labor and financial capital. As a result, countries would be required to lower their tax rates with respect to certain types. Such process has an important effect on the design of the countries' tax systems and may lead them to adopt tax structures that are regarded as less desirable and that they would not have adopted had their economy continued to act as a closed economy.[42]

In addition, unless they can find other sources to finance their public spending, countries will be required to lower their amount of spending. Thus, as it is further developed below,[43] in the absence of cooperation, internal inefficiencies and lack of equity might increase with more tax being levied on the less mobile sources of income, even though it is not certain that such measures would assist in regaining the lost revenues.

[40] As Roxan (2003b) notes, from the narrow perspective of efficiency, a system that is at a pareto-optimum efficiency does not necessarily have to be fair or to accommodate any further goals. For example, in a market of three participants A, B and C, a point of Pareto-optimum is achieved when A has income of 100 while B and C have 0. Nonetheless, this market, although being efficient, is not fair. In order to satisfy other objectives, it would be necessary for to find another point of pareto-optimum that would also satisfy the other goals while maintaining efficiency in the markets.

While one Pareto-optimum can be preferred to another and while arguably no efficiency loss should result if we are to move directly from one optimum to another, this is not that simple in practice. In practice, moving from one optimum to another may involve departing the point of Pareto-optimum which might lead to putting some participants (taxpayers) and also the entire market in a worse off position (at least temporarily). While overall, if we at the end of the process reach again to a Pareto-optimum, then as long as we do not exceed this point, the amount of loss in the system should be compensated by the amount of gain in the system. However, two problems arise. First, the transfer may give rise to non-lump sum taxation due to the loss of efficiency. Second, once the market regains it's point of Pareto-optimum, it is unclear how do we compensate those participants who are worse off as a result of the changes.
[41] Tanzi (1995).
[42] Tanzi (1995).
[43] See pp. 32-34 and 54-58 below.

In this process, ITA increases the potential inefficiency in the markets by encouraging certain tax driven transactions and financial investments that in the absence of ITA would either not be taken or would have been taken but at a higher cost for the taxpayers (and more revenues to the tax authorities).[44]

From a neutrality perspective, a tax system should try, to the extent possible, to remain neutral and to avoid any influence on taxpayers' behavior and the exercise of their investment and saving choices. As it was defined by a leading UK policy textbook, "*[A] neutral tax system is one which seeks to raise revenue in ways that avoid the discretionary substitution effects we have described; it is designed to minimize as far as possible the impact of the tax structure on the economic behaviour of agents in the economy.*"[45]

Given the fact that tax by its nature is a non-neutral intervention pursuing this goal is often easier said than done, especially when other principles and restraints (some of which are designed to be non-neutral and affect the taxpayers' decisions to follow one way over the other) co-exist and affect the policy decision making process. However, a relatively neutral tax system does not require that tax will not affect the pre-tax situation at all but rather that the effect on the decision making process of the taxpayer will as minimal as possible.[46]

For example, if both equity and debt are taxed in the same way, the pre-tax situation is not similar to the post-tax situation because tax is imposed and the taxpayer is left with less post-tax income when compared with his pre-tax income.[47] However, since the tax is imposed in the same way with respect to both types of investments, the tax does not affect the decision on the choice of investment.

The neutrality principle is not an absolute principle. Sometimes, a country may decide to use the tax system to promote or encourage a certain activity. In such case, the country would violate the neutrality principle by creating legislation that is designed to intentionally affect the decision of the taxpayer with respect to certain activities or investments.[48]

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[44] Edgar (2003).
[45] Kay & King (1990) at 18. With neutrality there is an overall assumption that a minimal degree of intervention cannot be avoided (otherwise there could be no taxes, for example). The question is whether a second best situation (of minimal intervention) is better than, for example, another second best situation.
[46] Arguably because if we take the alternative approach then the mere imposition of taxes is a non-neutral act and so taxes and neutrality can never co-exist. In addition, there are many market imperfections that we live with as, for example, the need for some public goods.
[47] Kay & King (1990), *ibid.*
[48] For example, the decision to grant accelerated depreciation or generous writing off allowances to promote acquisition of capital assets.

Neutrality and efficiency do not always go hand in hand. For example, if we accept the position that the pre-tax system is inefficient, a market failure,[49] (prior to the imposition of taxation) then a tax neutrality approach may not serve efficiency. In an inefficient system, supporters of efficiency may wish to use the tax system as a tool to adjust and encourage activities thereby removing the market failure, achieving a better allocation of resources and as a result a higher efficiency in the markets. In this way, the principle of tax neutrality would have to be set aside to allow promotion of competition and better allocation of resources among taxpayers. [50]

CEN (& CIN) and inter-nation neutrality

In the international dimension, tax neutrality is usually measured in the light of the benchmarks of capital export neutrality (CEN) and capital import neutrality (CIN), both aimed at maximizing the worldwide economic efficiency.[51] CEN is defined as taking place where a tax system is neutral with respect to the export of capital since investors face the same marginal effective tax rate on income from similar investments, whether they invest domestically or abroad.[52] CIN, on the other hand, is defined as taking place when domestic and foreign suppliers of capital to any given national market obtain the same after-tax return on similar investments in that market (taking into account both the corporate and individual taxes paid in both the country of residence and the country of source).[53]

Both types of neutralities are thought to lead towards worldwide economic efficiency maximization. It is generally understood that in the absence of harmonization of the world's tax rates, these two principles cannot co-exist in the same tax system.[54]

In general, there is support for each of these concepts. Most economists, however, prefer CEN, which promotes neutrality with respect to investments, to CIN, which promotes

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[49] Market failure does not concern the participants' willingness to gain a monopoly status in the market but rather the market's (or the market's forces) failure to prevent this by allowing one or more participants to gain the monopoly status.

[50] For example, it can be argued that an efficient allocation of resources requires the existence of a certain degree of competition in the market and that in the absence of existing competition it may well be that the tax system should be used to facilitate such competition. This argument will be discussed further below. See also – Dagan (2003).

[51] There is also a third benchmark, National Neutrality (NN), which supports a maximization of the national welfare (instead of worldwide welfare). This benchmark is less supported and will be addressed below.

[52] OECD (1991) at 18.

[53] OCED (1991) at 18. See also Graetz (2001) at 1364. It should be noted, that there is also a third alternative, National Neutrality (NN). However, while this alternative promotes the overall national (as opposed to worldwide) efficiency, it is perceived by many commentators to be too short-sighted and thus failing to achieve its goal on the long-term.

[54] Easson (1991) at 11.

neutrality with respect to saving as the guiding principle.[55] Even if all countries would decide to fully adopt one of these policies, there will only be partial neutrality.[56] Nevertheless, no country has yet to adopt either principle completely.[57]

According to Avi-Yonah, one of the main objections to ITA is efficiency and to be more precise, CEN.

"*The typical argument against undertaxing income from cross-border transactions is made in the name of capital export neutrality. If taxpayers invest abroad and by using international tax arbitrage earn higher after-tax returns than on domestic investments earning higher before-tax return, they will prefer the former investments over the latter. Thus, resources will be allocated away from their most productive use, resulting in diminished global welfare.*"[58]

Countries following CEN would attempt to create equality between the tax treatment of investments abroad and domestically, so that, all other circumstances being equal, a taxpayer resident in a country that follows CEN should not have any tax incentive to invest abroad (as opposed to domestically).[59] This is usually achieved through the adoption of two separate but connected policies.[60]

Thus, theoretically, a country that follows CEN as a tax policy goal would prefer not to allow an incentive for taxpayers to invest or operate abroad (instead of domestically). If CEN is violated because there is an after-tax incentive to invest abroad even though the pre-tax return is better domestically.

"*The result is a deadweight loss from a global efficiency perspective because investments will not be allocated to their most productive (highest-yielding) pretax uses. In the long run, as more capital flows to host-country investments, the pretax returns on those investments will fall and pretax returns on home-country investments will rise until equilibrium is*

[55] Easson (1991) chapter 4. See also Graetz, (2001) at 1366.
[56] The issue of partial neutrality (or relative neutrality) is discussed by Vogel (1990) at 59.
[57] This is mainly due to other considerations such as revenue loss etc that are taken into account in the decision making process.
[58] Avi-Yonah, (1999-2000) at 171.
[59] The taxpayer is thus subject to tax on his worldwide income and to prevent situations where investments abroad result in a higher tax burden, the taxpayer is also entitled to a foreign tax credit to alleviate the foreign tax burden.
[60] On one hand, such a country should tax its residents on their worldwide income and not allow for any deferral of taxation through the use of foreign subsidiaries. On the other hand, such country should also allow its taxpayer to obtain full tax credit with respect to income taxes paid abroad without any limitations. This is not only because of the unavailability of the full foreign tax credit but also because all countries today allow their taxpayers some degree of deferral with respect to income from foreign sources.

restored (when after-tax returns are equalized). The deadweight loss, however, will remain the same because some less productive host-country investments will be made at the expense of more productive home-country investments (that is, capital will be oversupplied in the host country and undersupplied in the home country)."[61]

In a more conventional situation, the encouragement of investment abroad (for example) is achieved through the combination of low statutory tax rates together with exemption or deferral of taxation of the foreign income by the country of residence. In the case of ITA, this is not the situation.

Prima facie, there is no deferral of domestic taxes and the statutory tax rates are relatively high. In these scenarios, however, the incentives to investment abroad are given through the use of the differences in the structure and computation of the tax bases in the relevant jurisdictions involved.[62] The "distortion" is not within the tax system but rather outside it. Each tax system includes provisions which are neutral in their treatment of domestic transactions and similar cross-border transactions and it is the interaction between the country Y tax system and country X tax system, which is the reason for the "distortion".

A similar argument can be made on behalf of CIN, for example, from the perspective of a source country allowing for a deduction in a double-dip cross-border leasing situation, arguing that allowing the second depreciation deduction is contrary to the principles of CIN. Yet, the question of neutrality looks at neutrality in general and is not limited to specific benchmarks as CEN and CIN.

Thus, the OECD has recognized that

"Issues of international taxation are more complex to deal with since they involve the interaction between national tax systems and tax treaties. The approach adopted in this report is to evaluate the tax treatment of cross border investment flows against the criteria of capital import and capital export neutrality....These concepts are used as benchmarks by which to judge the efficiency effects of international tax arrangements. Yet these neutrality benchmarks cannot capture all of the complexity of these arrangements....Each of these decisions cannot be encompassed in a simple conceptual framework."[63]

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[61] Avi-Yonah (2000) at 1604-1605.

[62] Basically, the problem is that the tax base is different whether it is due to different characterization (of either the transaction or the type of income), or to different methods of computing and measuring it. Thus, the premise that the tax base is similar can not be sustained anymore.

[63] Jeffery (1999) at 8 quoting OECD (1991) at 14.

Jeffery suggests that neutrality should not be seen as an absolute ideal (an all or nothing question). Instead of one single approach to an overall "neutrality", we should focus on different neutralities, each examining the level of neutrality as between two or more alternatives that are compared. Thus, for example, CEN comparing the treatment of investment abroad and investment domestically. These benchmarks are only good as long as we apply them in the context in which they are set.[64]

Both CEN and CIN are determined separately by each country at the national level. Having a situation, like with ITA, whereby a domestic treatment of the taxpayer and of the transaction is completely neural and despite that there is still lack of neutrality because of the interaction with another tax system, leads us to question whether countries should revisit and design their tax systems in a way that would eliminate these potential lack of (external) neutralities i.e. does the concept of neutrality, even when conducted by different countries at the country level, requires them to go outside the limits of their tax systems and to adapt the system to react to the different external lack of neutrality.

CEN can no longer be satisfied by looking at the taxpayers' tax situation only from the perspective of the country of residence (in CEN). Instead it is necessary to adjust the treatment in the country of residence based on the nature of the external distortion. In other words, full neutrality (CEN) can only be achieved through coordination of both tax systems, of both the country of source and the country of residence.

Regarding CIN, it is known that a successful CIN policy cannot take place unless the country of residence (which is not the country whose policy is being discussed) uses exemption as foreign tax relief. As long as the trading partners of that country of source apply different tax rates and employ the credit as their foreign tax relief mechanism, there can be no CIN.

Thus, countries that would like to achieve inter-nation neutrality (for example, in the export of capital) would be required to ensure that the taxpayers are subject to the same effective tax rates regardless of the applicable statutory tax rates.

Moreover, it is no longer sufficient to ensure that the taxpayer is subject to the same tax burden because several of the occasions of ITA go even a step further. In these situations the taxpayers' direct tax burden is not altered (by the ITA) but the transactions' overall tax

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[64] Jeffery (1999) at 9.

burden is reduced as a way to encourage certain activity. As a result, both efficiency and neutrality are violated.[65]

Another point that has to be taken into consideration is whether the maximization of worldwide welfare is the desired goal (as opposed to maximization of domestic/national welfare). This issue is discussed below.[66]

[65] For example, cross-border leasing.
[66] See pp. 38-42 below.

The Equity Debate

There are two types of equity that should be maintained: inter-individual equity and inter-nation equity. The first type is divided into two sub-categories: horizontal equity and vertical equity. Horizontal equity requires that taxpayers earning the same amount of income pay the same amount of tax[67] while vertical equity requires taxpayers who are not in similar circumstances will not be subject to the same tax burden in a fair way that those who have more carry a heavier burden and are required to pay more taxes, justifying the application of proportional and progressive taxation.[68]

A tax system that does not follow equity at all may become unfair and unjust to its participants. As a result, a system risks the possibility of taxpayers' unwillingness to participate in it due to their lack of trust in the fairness and justice of the system.[69]

The way in which a country that adheres the principle of horizontal equity manages to ensure the principle is maintained also in the international dimension is by taxing its residents on a worldwide basis (without the availability of deferral) while allowing them a full foreign tax credit with respect to foreign tax paid. In that way, the taxpayer is not treated differently from his colleague who has only domestic income.

Since, however, the entire concept is based on comparing between persons in the "same circumstances" and distinguishing between persons who are not in the "same circumstances", it is of crucial importance to define what "same circumstances" means and whether it is possible for two persons to be in the "same circumstances". The result of the analysis depends to a large extent on the choice of comparable persons.

In the case of individuals, the debate is usually between individuals, couples, families or households as the tax unit. This becomes more complicated if we try to apply similar

[67] This can be demonstrated in the following way. Assume that we have taxpayer A who derives all of its income from domestic sources in the country and taxpayer B who derives some of his income from domestic resources in the country and some of its income from foreign source located outside of the jurisdiction. If we are to maintain the principle of horizontal equity, then assuming both A and B earn the same amount of overall income, then both should be pay the same amount of taxation.

[68] The basic rationale behind this concept, which is based on the notion of fairness and justice, is to increase the fairness of the system and to encourage the different taxpayers to participate and pay the required tax. Even though the tax by its nature is usually a compulsory liability that is imposed without direct reference or relations to the amount of services or goods that the relevant taxpayer is receiving from the state, the idea is to create a system in which no taxpayer is under a disproportionate burden of taxes, usually when examined vis-à-vis other taxpayers.

[69] This unwillingness to participate in the system may not be shown in a direct way. Rather, it can be shown in an indirect way through eager attempts of taxpayers to reduce their tax liability. It should be noted that equity is measured and examined only among the members of the same jurisdiction. There is no notion of equity between taxpayers from different jurisdictions (or different tax systems). Thus, in a sense a tax system is regarded as a close society for examining the notion of equity.

concepts to the taxation of companies and their shareholders and even more complicated once groups of companies are being considered (for example, a domestic controlled domestic company and a foreign controlled domestic company – are they under similar circumstances?).

In addition, it is important to have some sort of normative criteria to allow more practical application of the equity principle.[70]

Labor v. Capital[71]

An important aspect of the equity principle is that tax system should not prefer one type of taxpayers to another, again in order to make the system more reliable, fair and efficient. This latter point is illustrated in the tension between the taxation of income from labor and the taxation of income from capital. Preference of one type of income to the other might lead to an unequal treatment of taxpayers who have more income from that type over taxpayers who derive more income from the other type. This may result in putting disproportional burden of taxation on one type of income.

For example, if income from capital is taxed more favorably, then income from labor is taxed more heavily and in a way that is not proportional to its share of the overall income. This inequality might result in fewer tendencies of taxpayers who are deriving most of their income from labor to participate in the tax system and to bear the burden of tax.[72]

To the extent that the taxpayer cannot alter the circumstances so as to increase his income from capital at the expense of his income from labor (or his income from abroad at the expense of his income from domestic sources) then we are dealing with a question of equity and fairness among taxpayers (as opposed to efficiency).[73]

According to Avi-Yonah,

"As revenues from both the individual and corporate income taxes have been generally flat – as a percentage of total revenues—over this period, the increase in total tax revenues was financed by increases in consumption taxes in all countries and in payroll taxes in developed

[70] See generally, Herman (2001).
[71] This argument was originally used and dealt with specifically by Avi-Yonah (2000).
[72] There is also an important effect from an efficiency perspective i.e. that such a tax system encourages capital investment over labor – this might lead to a reduction in the productivity (see also below).
[73] To the extent that the taxpayer can alter his position, the question is one of efficiency, a question discussed above, pp. 23-30.

countries. Because both consumption taxes and payroll taxes fall on labor, whereas income taxes may be imposed on both labor and capital, the data are consistent with the shift from taxing capital to taxing labor predicted as a consequence of globalization."[74]

Linking back to our point above regarding the relationship between equity and efficiency, "*[B]ecause labor is less mobile than capital, it is generally not able to turn the inequity into an efficiency by moving to countries with lower tax rates. Moreover, because capital income accrues disproportionately to the rich, the shift in tax burden from capital to labor has tended to make all the societies less equitable in terms of distribution of income or wealth. Remedying this situation calls for finding ways to tax capital despite its relatively high mobility.*"[75]

According to Avi-Yonah, ITA is violating the fairness principle which is at the center of the equity principle. As a result of the distinction that ITA makes between taxpayers who earn domestic labor (and in certain circumstances, even capital) income and taxpayers who earn capital income overseas and can thus benefit from ITA.[76] Not only that. ITA is only available in limited situations. These situations have a cross-border element and are only available to taxpayers that engage (and can afford to engage in) in cross-border investments. In that respect ITA represents an additional violation of the equity principle.

ITA also violates the efficiency in the market by potentially increasing the burden on income from immobile labor (income that can be referred to as "locked in income" due to its immobile nature) and reducing the burden on income from mobile capital.[77]

This argument, however, appears to be based on the premise that capital income is completely mobile whereas labor income is immobile and to disregard one possible outcome of ITA whereby it can be seen also as reducing the cost of capital, allowing more funds to be available for business and more funds to be available to be spent on other aspects of the business (including salaries and employees costs).[78]

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[74] Avi-Yonah (2000) at 1621-2, referring to the period of 1965-1995.
[75] Avi-Yonah (2000) at 1625.
[76] Avi-Yonah (1999-2000) at 172.
[77] This statement has to be qualified. First, the reference to capital is with respect to highly mobile capital. Second, the reference to labor is to immobile labor. This for example does not include highly skilled labor that can relatively easily emigrate from one country to another. Third, the assumption is that the non-tax conditions in the two or more countries are similar or relatively similar.
[78] With respect to the premise, as it is also discussed below, not all income from labor is essentially immobile and not all income from capital is completely or highly mobile. Nonetheless, it is possible to identify a group of capital income that is generally mobile and as a result is likely to be subject to a lower tax rate when compared to a group of income from labor that is immobile (usually, income earned by less skilled individuals).

This is quite in line with the "spill-over" argument. Arguably, the existence of ITA would reduce the cost of borrowing and of financing and increase the volume of transactions thus indirectly increasing the amount of economic activity. These changes would allow a country to obtain more taxes from other sources, taxes that would compensate for the apparent loss of resources from ITA transactions. However, even assuming that other taxes distort less, this argument does not solve the problem at stake and does not balance the imbalance between the taxation of income from labor and the taxation of income from capital.

It can be argued that ITA merely spreads the heavier burden that is imposed on income from labor over more overall income (and possibly more taxpayers) or uses the higher taxes on labor to raise more revenues from taxpayers who would now earn more from their labor and would be able to contribute more taxes to compensate for the apparent loss. In effect, while the "spill-over" argument may serve as a counter argument to counter the opinion that ITA results in revenue loss, it would probably not help in the labor v. capital imbalance. On the contrary, it might widen the difference. I shall revert to this question from a different perspective in the discussion on competitiveness and tax competition and on revenue loss below.[79]

Inter-nation Equity

In addition to the inter-individual equity, some writers have suggested that with the international economic integration, we should also look at equity among nations. This principle, named "inter-nation equity" recognizes that in addition to the inter-individual equity, there should also be some sort of justice between nations with respect to the allocation of revenues from global operations. [80]

True, there is no agreement relating to what should be the proper allocation of the tax base. In addition, there is no principle of fairness that can be used to justify a certain allocation of the tax base.[81] Thus, as Easson points out, one of the main obstacles in applying this standard is to determine how and when to strike the balance between nations so there will be a state of inter-nation equity.[82] This, however, does not mean that there is no way of allocating income among nations.

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[79] See pp. 54-58 and 59-61 below.
[80] Jeffery (1999) at 1.2.2.2. This is as opposed to among individuals from different countries, which does not exist.
[81] Easson (1991) at 20.
[82] Easson (1991) at 20-21.

Herman discusses three approaches to the allocation of income.[83] The first approach, Peggy Musgrave's approach, the "national entitlement" approach, based on the understanding that both the residence and the source countries are entitled to tax the income which should be allocated between them.[84]

A second approach is the approach taken in 1920s by the League of Nations and its group of four economists based on the concept of "economic allegiance". The main difference between this approach and the first approach mentioned above is the existence (or rather lack thereof) of a residual right to the country of residence to tax the income that is allocated to the country of residence but is partially or fully exempt by that country. While this residual entitlement exists under Musgrave's approach, it does not under the economic allegiance approach.[85]

The third approach recognized by Herman is Avi-Yonah's proposal for an inter-nation redistribution. According to this approach international tax law rules should be designed in a way that would ensure a fair redistribution of income among nations. Thus, inter-nation equity, in the absence of other mechanisms, is seen as the tool for redistribution and reducing the tension and inequalities among the different nations.[86]

Avi-Yonah recognizes that there is no international tax authority to govern such distribution, and precisely because of this absence, argues the case for redistributive inter-nation equity and finds some support for this argument in current international tax law practice.[87]

Moreover, if we take the position that "beggar thy neighbor" is not a good tax policy (at least not for the long-term)[88] and that different countries are better off only to the extent that the wealth is shared among all nations in a relatively fair method, then such an approach as presented by Avi-Yonah should be included in the overall tax policy goals. This approach would appear to agree also with strive to achieve worldwide efficiency.[89]

According to the existing approach, which is also evident in many existing tax treaties, in the case of passive and portfolio income the country of residence is the country that has the right

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[83] Herman (2001) Chapter 2 at 26.
[84] Herman (2001) Chapter 2 at 26.
[85] Herman (2001) Chapter 2 at 26.
[86] Avi-Yonah (2000) at 1649.
[87] Avi-Yonah (2000) at 1649-1650.
[88] See also the discussion in the context of competitiveness below (pp. 54-58).
[89] In this context to the extent that the markets reach the point of Pareto-optimum prior to the satisfaction of the redistribution goals, the task of redistribution will probably be done outside the tax systems so as not to violate the efficiency of the markets.

to tax the income while the country of source has a very limited (or at all) right to tax that income. On the other hand, in the case of active income, provided that the income has sufficient connection to the country of source, then this country has the right to tax the income (without any limitations) while the country of residence has a limited residual right (if at all) with respect to this income. This approach, however, is based on the state of the world, as it existed many years ago when the concept of taxing international income and the types of international income to be taxed were completely different from what takes place today.

In this context, it seems that Avi-Yonah's approach is probably the desired approach to be taken in future time to allow better allocation of resources among the different countries of the world. While this approach is not free from problems or objections it can nevertheless be a valid approach if we believe that one of the main purposes of a tax system is to redistribute income among its different participants.[90] The main obstacle is of course persuading countries (those who are already better off) to agree.

In the absence of a world tax authority (or an agreement to that effect) that would ensure compensatory payments are made from the countries that are better off to those that are worse off, the only way in which countries will be inclined to join in is if each country can satisfy itself that such move is in its best (self) interest. In other words, the challenge is to persuade countries that are better off today to give up some of their existing benefits in exchange for other benefits in an overall better off world, benefits that would make these countries better off as well, which is in effect a long term Pareto improvement.[91]

The challenge is to manage, through cooperation, to achieve a mechanism whereby the countries that lose from the changes in the inter-nation equity are compensated through other means. That is, to create a redistribution mechanism that would allow such compensation. The absence of such a mechanism can explain the desire on part of countries to stress the importance of national welfare maximization (As opposed to worldwide welfare maximization).

[90] Some of the problems associated with this option are as follows: (1) how do we determine the extent and method of re-distribution among nations, (2) the redistribution option requires states to forgo their own interest for a global interest based on the assumption that if everyone is happy then it is better for all states including those who forgo something (it also implies that a situation whereby some are losing is bad even to the better off states that are not (directly) affected). The challenge is to find the way to persuade those better off states to follow and adopt this line of argument.

[91] As discussed below, certain benefits, like a relative power in the global market or domination might be "lost" for good in a better off world.

Although there is not always a contradiction between the two goals, there is no complete similarity and the end –result might prove detrimental to some of the countries while being beneficial to others. It might not be a Pareto improvement but society might still consider it to be better.

"Thus, it is not evident that the national economic interest is equivalent to efficient wealth maximization at the global level, a proposition of Ault and Bradford. Maximization at the global level does not give any indication as to who will generate the tax proceeds. It would be more obvious for policy-makers to aim at maximizing wealth for their own country."[92]

A redistribution mechanism is supposed to take care of this problem and to assure those countries that are likely to be worse off are being compensated for their loss. As a result, countries would tend to prefer maximizing national welfare to maximizing worldwide welfare.

ITA represents a potential for altering the existing balance by preferring one route of investment or one type of investment to another and by providing a tax incentive for investing in one country to another. Whether ITA results in a better or worse allocation of revenues among countries depends on the model of redistribution that is used and would require more analysis. It appears, however, that in the absence of an agreed upon mechanism for redistribution and cooperation among countries, ITA might lead to undesired results. First, in the absence of a compensatory mechanism, ITA is likely to be opposed by those countries that appear to lose from the incident of ITA, depending on the situation. Second, the absence of a redistribution method prevents us from being able to evaluate whether ITA in a specific situation is beneficial or detrimental to the overall result of the redistribution, to the end-result of the inter-nation allocation.

In the absence of such redistribution mechanism, each country is likely, to a large extent, take care of its own interest unilaterally. In that respect, changes in the inter-nation equity might serve as a justification to allow or to prevent ITA, depending on whom you ask.

[92] Daniels (2001) at 5.

Graetz's Critique and the International v. National Level Discussion

After discussing both equity and efficiency, which are regarded as the building blocks of tax policy discussions, it is important to pause and examine the recent critique that was put forward by Graetz. Although the critique is mainly aimed at the US tax system, I believe that it is applicable, with certain adjustment, to tax policy discussion on the taxation of international income in general.

According to Graetz's argument, worldwide economic efficiency receives too much importance in academic analysis while in practice, to a large extent, it is not being followed. In fact, other principles and considerations, like equity and foreign policy, should receive more attention.[93] In addition, its focus in the case of efficiency is inappropriate and should instead be at the national level.[94]

Seeking worldwide economic efficiency on the other hand tells policymakers to "*respond with equal vigor to avoidance of a foreign country's taxes and avoidance of US taxes.*"[95]

The important point, however, is that worldwide economic efficiency "*urges policymakers to embrace the larger benefit without regard to where it occurs or who benefits. Worldwide economic efficiency does not heed love of country. But why should a US President or members of Congress put aside "narrow" national interests to fashion US tax policy in a manner apathetic to whether benefits flow to US citizens or citizens of other nations?*"[96]

As Graetz mentions earlier in his article, "*Tax policy decisions, including decisions regarding a country's tax treatment of international income, should be, and inevitably are, decided based on a nation's capacity, culture, economics, policies and history. In democracies, such decisions are determined by the votes of the nation's citizens and their representatives. Taxation without representation is still a tyranny.*"[97]

This is a very important point in the understanding of ITA which, to a large extent, results from different perceptions by different countries of the same transactions. A blind following of economic principles towards harmonization by adopting a single principle would thus disregard the important contribution of the culture, policies and history to the state of the law in each country and to the policy decisions that have been made so far.

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[93] Graetz (2001).
[94] Graetz (2001) at 1373-1374.
[95] Graetz (2001) at 1375.
[96] Graetz (2001) at 1375.
[97] Graetz (2001) at 1374.

Graetz's starting point is history and he is examining the situation that existed then, starting in the 1920s and moves to the situation today. Despite all the changes that took place in the world's economy since the international tax regime was put into place and despite the strain that the new reality has on the existing set of rules, the US Congress (and other governments) have chosen not to do anything to change the rules so that they better accommodate existing reality. [98]

Based on this introduction, Graetz goes on to explore these inadequate principles of international tax (as he refers to them). Graetz criticizes the focus on tax neutrality and the use of existing benchmarks (CEN, CIN and NN to which he refers to as "a two by three matrix") and the inappropriate weight that is given to them in tax policy (especially with respect to equity and its supposed role).

"*In domestic tax policy, fairness in taxation tends to hold center stage. ...The dominant normative perspective of international tax policy debates – limited to a choice or a compromise between CEN and CIN – both inhibits an adequate understanding of the normative underpinnings of international income tax policy and improperly limits serious consideration of alternative policies.*"[99]

Graetz's first critique is that policy discussions are made with respect to national rather than international or global perspective. Worldwide efficiency, for example, should be replaced with national efficiency (and efficiency itself should not play a leading role in international tax policy).

Graetz views the general criticism of national efficiency and on the use of NN (national neutrality) as misconceived. The mere fact a policy like NN has its shortcomings does not necessarily lead to the conclusion that national efficiency (which is associated with NN) should be rejected altogether). According to Graetz, making up the best policy to further national efficiency sometimes requires the combination of one or more policies together based on empirical evidence. The important issue is that in doing so, the question to ask is how to lead to national efficiency as opposed to worldwide efficiency.

In addition, Graetz argues that the view taken of efficiency is a too narrow view.

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[98] Graetz (2001) at 1362.
[99] Graetz (2001) at 1370-1371.

"As I have indicated, when evaluating these rules (or other international income tax provisions), economists today seldom ask how these rules affect the economic welfare of US citizens or residents. Instead, they generally accept worldwide economic efficiency as the operative norm, and generally conclude that the United States should follow a policy of capital export neutrality."[100]

The starting point for Graetz is Peggy Musgrave's seminal analysis of efficiency aspects of foreign investment,[101] an analysis that includes a reference to national efficiency only in the form of NN.[102]

Graetz presents his seven points of criticism to Musgrave's approach.[103] First, he reminds us that the work was conducted in the 1960s when the world was quite different from its current state. Second, he points out that Musgrave's assumed, like most economists, a first best world, "which markets are perfectly competitive and governments are well balanced".

Third, Musgrave's work assumes a dollar for dollar substitution of domestic investment by foreign investment. However, Graetz points out that there is evidence to support a claim that foreign investment is actually complimentary (rather than substitutive) to domestic investment and can provide companies with more capital to finance more domestic investments.[104]

Fourth, Musgrave ignores the individual level of taxation whereas evidence shows that the US, for example, receives more taxes from foreign operations of US companies by taxing individuals than by taxing the corporations themselves.[105] Fifth, the analysis conducted by Musgrave took place when the US was the world's biggest capital exporter thus it focused only on direct outbound investment. Today, however, the US is also the world's biggest capital importer (not to mention the amount of cross-border portfolio investment that was added in recent years to direct investments) and thus an inbound investment analysis is also required.[106]

Sixth, Musgrave's analysis does not take into account the reaction of foreign governments to the US policy decisions and legislation changes. Due to this point it is necessary to examine

[100] Graetz (2001) at 1379.
[101] Musgrave (1963) and Musgrave (1969) both referred to by Graetz (2001) at 1380.
[102] Graetz (2001) at 1381.
[103] Avi-Yonah summarizes some of the critique on Musgrave's analysis in Avi-Yonah (2000) at 1609.
[104] Graetz (2001) at 1385.
[105] Graetz (2001) at 1386.
[106] Graetz (2001) at 1387.

policies at the global level as well as at the national level (i.e. to examine possible reactions by other jurisdictions etc.) to ensure that other participators in the markets are not too adversely affected by the domestic policies. This seem to be based on the premise that in order to achieve a better world we have to ensure that it is better for everyone and not only to a selected group of participants.[107]

The last point is that the analysis overlooks the possibility of improving the welfare of the citizens/residents through cooperation with foreign governments.[108]

The two important points that can be taken from Graetz's critique are that it is necessary to examine each country's self-interest and not only focus on the worldwide perspective and that there are other important policy goals that play an important role in addition to efficiency that receives too much attention in policy discussions.

I agree that tax policy, despite the global markets, is a national rather than international determination and as such should seek to further national rather than international welfare. In the absence of a world tax organization or any agreed upon method for redistributing tax revenues among countries and due to the link between taxpayers and government ("no taxation without representation"), taxation is to a large extent still based on the determination of policies at the national level. This, however, does not always contradict maximization of worldwide welfare.

Graetz is correct in arguing that economic efficiency is not everything and that equity (and in my view also inter-nation equity) and foreign policy should receive their appropriate consideration. However, this does not mean that the idea (or rationale) behind worldwide economic efficiency is not valid. In fact, this rationale seems to support Graetz's argument.

Looking at the national interest in each country does not prevent countries from achieving and maximizing global efficiency. It is quite possible to have a competitive market that would strive to maximize the global welfare through the participation of the different players each trying to further their own self-interest. Thus, furthering the countries (participants) self-interest does not necessarily stand in contradiction with maximization of global welfare. The only caveat is that in doing so, countries should ensure not to further their own interest at the expense of reducing the overall resources.[109] To do that, it is necessary to establish a

[107] Graetz (2001) at 1389.
[108] Graetz (2001) at 1390.
[109] Roxan (2003b) at 6-7.

redistribution mechanism not only at the domestic level but also at the international level to compensate those who become worse off. As discussed above,[110] there is more than one point of Pareto-efficiency and at the same time, Pareto-efficiency does not tell us anything about other considerations outside efficiency. For example, equity. For that reason, it is necessary to insert the other considerations and to achieve a Pareto-efficiency that also satisfies these other considerations. In the absence of a redistribution method, countries would tend to use other considerations to ensure that the allocation of resources reached is also favorable to them taking into account other considerations as well. For example, to ensure that at the end of the day, they have sufficient funds to allow them to finance their public sector. To that extent, some countries considerations might come at the expense of efficiency.

An interesting point that is that national self-interest, unlike national neutrality, is dependent upon the reaction from other participants (other countries). As a result, in determining what is the self-interest of each country, the country has to take into account the acts of other countries, which might have an effect on the first mentioned country. In making policy choices, a country acting in its self-interest and in an uncooperative environment will tend not to take decisions that might result in worsening its position, even if there is a change that it would improve its position as a result of the decision.[111]

Thus, following worldwide economic efficiency should place countries in a position that would make everybody better off while not making anyone worse off which in a way is embodied also in Graetz's argument. This, however, is subject to one important caveat. It assumes that overall, no country will lose out. Going outside the narrow scope of the efficiency principle, in the absence of a redistribution mechanism and coordination, countries would tend to adopt different approaches using non-economic policy considerations, as for example, foreign policy and subject to domestic restraints, as for example, political considerations.

[110] See pp. 23-24 above.
[111] For example, game theory.

Competitiveness

> *"[Tax policy] has traditionally been thought of as an entirely domestic matter. [But] in an increasingly global world economy, nations can no longer afford to design their tax systems without accounting for the effects on international trade and investment."*[112]

The desire of countries to ensure that their taxpayers are not disfavored vis-à-vis foreign corporations (whether it is in outbound or inbound transactions) is a known concern and policy aim. This is especially true for more developed countries that are capital exporters and wish to ensure that their taxpayers are not "worse off" vis-à-vis "comparable" foreign taxpayers (and that other less developed countries are not using aggressive tax incentives to pull income flows from developed countries to these less developed countries).[113]

On one hand, these countries are aware of the risk that if their taxpayers become less competitive because of their tax system,[114] they risk losing these taxpayers (especially corporate taxpayers) who might decide to relocate to a more competitive environment.[115] [116] This can result in a tendency on part of countries not to attack or at least to be indifferent with respect to outbound ITA.

On the other hand, since these countries are not in a desperate need for foreign investment, they may be disinclined to grant all advantages to foreign taxpayers unless there is a serious risk of a reduction in foreign investment. For example, inbound ITA that is available to non-residents that are competing with residents for whom the ITA is not available. [117]

Over the years, the competitiveness argument has been used both in support and against legislative intervention to ITA. This argument is often used in the ITA debate, not always in the right way and for the right reasons. In the following section I explore a few of the main issues regarding the competitiveness argument to provide the basis for using this argument in the discussion elsewhere in this work.

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[112] Joel Slemrod, quoted by Steinmo (1993) at 156.
[113] One thing that may be questionable is to what extent the competitiveness of business entities from country X is actually beneficial to country X and to the welfare of its taxpayers. This question is discussed below. Until then, I shall assume that such a link exists and that it is beneficial for country X to have its business entities more competitive vis-à-vis foreign businesses.
[114] I.e. the tax system becomes (or is at least perceived as) a burden on the ability of these corporations to compete in the global economy.
[115] For example, see US inversions techniques discussed briefly below (pp. 102-104).
[116] This might be more likely in the EU , if for example, the relevant taxpayers can find a better alternative within the EU to put their headquarters (or center of operations) in. To that extent it is quite likely that the UK is more exposed to this "threat" than the US.
[117] For example, IRC §894(c) and §1503(d) and the regulations thereunder.

Neutral Competitiveness and Maintaining a Competitive Edge

Competitiveness as referred to in this work includes two types of competitiveness, neutral competitiveness and maintenance of a competitive edge.[118]

According to the latter, the country promoting competitiveness would try to ensure that the use of competitiveness leads to a situation whereby that country and/or its taxpayers are in a better situation vis-à-vis other countries (or taxpayers from other countries), not necessarily an equal situation. According to the former, the goal is to put both sides on a level playing field, by eliminating (or reducing) the effect of tax.

From an efficiency perspective, it appears that neutral competitiveness is preferred as it is aimed at eliminating the distortions created by the tax systems. Adopting competitiveness with a view of maintaining a competitive edge is similar to a subsidy that is given to a taxpayer/transaction to maintain its viability, in situations where such transaction would not be viable but for the tax advantage. Such benefit might be defendable in the short-term but might not be beneficial in the long-term.

Although it appears, at least from the outset, that these two types of competitiveness are quite easy to identify and separate, this in not always the case. The ongoing dispute between the EU and the US is a good example to illustrate this point as well as the general problems with competitiveness and the other policy considerations that are usually relevant in the discussion.

The origin of the this debate is more than thirty years ago when the US decided to, *prima facie*, support its manufacturers in their ability to compete aboard (mainly in Europe) vis-à-vis foreign competition but that was not the main reason.

The US CFC legislation, which was introduced less than ten years before that, allowed deferral under certain restrictions to manufacturing operations of US MNEs conducted abroad, even if the place where such operations were conducted was a low-tax jurisdiction. This created an incentive for US MNEs to move their operation abroad, enjoy the lower tax rate there and defer their US tax liability until the profits were repatriated to the US.[119]

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[118] An alternative definition is given by Roxan who defines the two groups as measures generating competition and home response measures which respond to existing competition. Roxan (2003a).
[119] Funk (2001).

Provided sound advice was given, taxpayers were able to structure their affairs in a way that would result in unlimited deferral of these profits.

As a result of this "*perverse incentive for U.S. corporations to locate businesses activities and jobs overseas*"[120], the US enacted in 1971 the predecessor of the Foreign Sales Corporations (FSC) legislation, the Domestic International Sales Corporation (DISC) legislation. This legislation allowed US corporations to set up subsidiaries through which the sales of their domestic manufacturing activities would be conducted. These subsidiaries would be subject to tax only with respect to part of their profits in a manner that would reduce their effective overall tax rate and would make US manufacturing more attractive for these US MNEs. To qualify, the subsidiaries had to engage in the sale of export property which was property that was held primarily for export, was manufactured in the US, and less than 50% of which value was attributed to imports brought into the US. In addition, US parents of these DISC subsidiaries were able to attribute to the DISC export profits that amounted to either 50% of the export profits or 4% of the gross export sales or a percentage that was reasonably determined based on the arm's length principle.

The DISC legislation was a huge success and within three months from its introduction, US MNEs managed to form 1,136 DISCs.[121] It did not take long for the European countries to sense the advantage granted by this legislation and to file a complaint arguing the legislation violated the principles of GATT being an illegal subsidy.

In 1981, a holding of the panel adopting the complaint was accepted by the GATT Council. Although the US never accepted that the DISC regime violated GATT, in 1984 the US Congress replaced the DISC regime with the FSC regime which effectively did the same with the addition of certain technical requirements that were meant to technically (although not in substance) satisfy the GATT requirements.[122]

More years have passed and the FSC was held to be an illegal subsidy. This did not prevent the US from replacing it with yet another similar regime but with a different name (Extraterritorial Income (ETI)), which was also held to be illegal subsidy. As of today, since both the EU and the US have yet to reach an agreement on how to proceed and with a

[120] Funk (2001).
[121] *Ibid.*
[122] *Ibid.*

decision against the US, the possibility of sanctions on US trades from a EU perspective seems closer than ever.[123]

The interesting thing is that this regime was initiated as a measure to preserve work places in the US. At the same time, this did not prevent others from arguing that the regime is meant to improve the competitiveness of US MNEs vis-à-vis foreign competitors that benefit from a more favorable tax system.

According to Funk, "*it appears that the major U.S. multinationals and labor unions are hooked on subsidies. The estimated tax benefits run nearly US$4 billion per year and are increasing... One of the few areas where business and labor interests can agree – and declare cease-fire from their disputes over healthcare and other programs – is export subsidies.*"[124]

But is it a good policy? It apparently improved the competitiveness of US MNEs vis-à-vis foreign competitors. Otherwise, there would not be such a strong opposition from the EU. It apparently improved the labor situation in the US adding more work places. Otherwise, it would not have received this strong support from the labor unions. So, arguably, it is a good policy for the US. Not necessarily.

The US has spent a lot of money sponsoring these subsidies and exemption from tax. This money was spent to keep US MNEs competitive while investing domestically to provide for domestic work places. I return to this issue below.[125] At this point, it would suffice just to raise the question whether or not the US would have been better off had this money been spent on finding US workers other work places to replace those lost while allowing US MNEs to invest move their operations abroad to places which are more efficient for them to operate from.[126]

Competitiveness – whose?[127]

Much discussion has been made in the name of competitiveness. Most of the time, the discussion is made without explaining what is meant by competitiveness, that is, whose competitiveness is it?

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[123] Bell (2004).
[124] Funk (2001).
[125] For example, in the context of cross-border leasing below (pp. 204-207).
[126] This question is further addressed below in the context of political considerations below (pp. 67-71).
[127] This question was raised by Avi-Yonah (1999) at 531.

Basically, there two possible answers: one possibility is that the reference is to competitiveness among the countries based on the competitiveness of their tax systems. In the world today, MNEs and taxpayers' ability to invest in more than one country result in "jurisdiction shopping" which necessitate countries to compete among themselves on investments.[128]

Another possibility is that competitiveness refers to the competitiveness of companies resident in the country vis-à-vis foreign competitions.[129] There are at least two problems with this approach. First, the long-term benefit of such an approach to the country is unclear and would depend to a large extent of the type of competitiveness that is contemplated.

Second, even if we only look at the short-term, the link between the competitiveness of the corporations and the benefits received by the general public of taxpayers resident in the country is not clear. For example, the competitiveness of the business entities may not make the members/taxpayers of the country any better off than without the competitiveness. Therefore, it might not already be in a country's best interests to create a competitive advantage to its resident companies.

This is especially true in the case of MNEs, which are publicly traded[130] and whose shareholders consist of many different nationalities, not necessarily that of the country of residence of the MNE.[131]

Thus, it is impossible to make an across-the-board use of the competitiveness argument as if it is beneficial in all circumstances. Rather, we should revisit this question whenever competitiveness is raised and ask whether in the particular circumstances the competitiveness that is sought is really in the best interests of the country and represents what the country should seek. [132]

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[128] For example, Intel which is mentioned by Avi-Yonah (2000) at 1589. An outcome of this competition is the harmful tax competition that is further addressed below. On this issue, see also Edge (2003).

[129] See for example, the discussion regarding the competitiveness of US corporations where the focus was on the competitiveness of the corporations not of the country or the economy. In this work, when a reference is made to the term competitiveness, unless it is provided otherwise, the reference is made with respect to the competitiveness of the corporations.

[130] It is quite possible that the company may not be registered for trade on a stock exchange in its country of residence. For example, NASDAQ consists of many non-US companies that are traded on the exchange.

[131] In addition, it might be the case that most of the multinationals' income would come from sources outside the country of residence of the parent company thus significantly reducing its tax liability in that country of residence.

[132] To rephrase Avi-Yonah, what is good for GM is not necessarily good for America (Avi-Yonah (1999) at 537).

As for the level at which competition is analyzed, this analysis is conducted at two levels. First, the countries level where different countries compete between themselves to become more attractive and competitive and to attract as much foreign income as possible. I shall discuss this level below in the context of harmful tax competition.[133] Second, competition that is examined at the companies level. It is necessary to identify the competitors before analyzing the validity of the argument.

Kingson's Approach to competitiveness[134]

The premise upon which competitiveness arguments are usually based is the examination of domestic corporations vis-à-vis foreign competitors at the international level. In the US, it is often a complaint by US MNEs that US tax laws put them in a competitive disadvantage vis-à-vis foreign competitors, usually because of the higher tax burden imposed on US MNEs' foreign income. Based on this argument, US MNEs seek for lower US taxation of active foreign income (usually earned through a foreign subsidiary) to make them more competitive abroad.[135] Such measures, however, might lead to foreign income being taxed more favorably and thus encourage US MNEs to incorporate foreign subsidiaries and to transfer operations from the US to these foreign subsidiaries.[136]

Kingson, in his discussion of competitiveness in the US context, claims that the existing discussion is too narrow and should include additional comparisons. The comparison should not be limited to corporations from country X competing with corporations from country Y with respect to the market in country X or in country Y or even in country Z. Instead, it should also look at corporations from country X that operate both in country X and abroad vis-à-vis corporations from country X that only operate in country X.[137]

According to Kingson, since the amount of revenue required to be raised as tax from the public to finance the public sector is usually fixed, giving up tax on one type of transactions/taxpayers might have a detrimental effect on other types of transactions/taxpayers that will have to "cover" for the insufficient revenues raised from the former group. Apart from questions of equity and efficiency, there are some important

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[133] See pp. 54-58 below.
[134] This part is based on Kingson (1991).
[135] The argument is based on the premise that US CFC rules are much wider in their application than other countries CFC rules. As a result, US MNEs are subject to current US tax with respect to income earned by their CFCs even when such income is active income from the conduct of business. To that extent, according to the argument, US corporations are at a competitive disadvantage vis-à-vis foreign corporations.
[136] See generally Rosenbloom (2004) and Brewer (2004).
[137] Kingson (1991).

domestic competition issues that might ensue as some domestic taxpayers might be subject to a lower tax burden than other domestic taxpayers.

If, for example, country X decides to improve the competitiveness of its resident corporations operating both domestically and abroad by reducing the tax burden on these corporations while limiting these benefits only to income from abroad, it discriminates against other country X corporations that only operate domestically. This can have the effect on the competitiveness of country X companies that only operate domestically both vis-à-vis other country X corporations that operate both domestically and abroad and vis-à-vis corporations from other countries that operate in country X.

To the comparison introduced by Kingson, it is necessary also to add another dimension, that the competition that takes place is not necessarily bilateral but can also be multilateral and involve taxpayers from more than two jurisdictions.

For example, a corporation resident in country X that operates in country Y does not have only country Y corporations as potential competitors but also country Z corporations that operate in country Y. Such corporations might enjoy a competitive advantage as a result of the interaction of the tax laws of countries Y and Z, a benefit that is not enjoyed by corporations resident in country X that operate in country Y.

Outbound and Inbound Transactions (Competitiveness as a two bladed sword)

The competitiveness argument does not exist in a vacuum and its scope as well as its possible application may vary depending on the nature of investment and its direction, which also affects the interaction between competitiveness and other policy considerations.

In the application of the competitiveness argument, several distinctions need to be observed. These distinctions apply with respect to tax treatment of cross-border investments in general.

A first distinction is usually drawn between inbound and outbound investments. In the latter, the two conflicting interests are usually the desire to keep domestic corporations competitive on the one hand and the desire to eliminate the preference for these corporations to invest aboard on the other hand. In this context, the competitiveness argument is usually used by domestic corporations in support of the former argument and in support of their competitiveness vis-à-vis foreign competitors.

With respect to inbound investments, the conflicting arguments are domestic corporations that wish to retain their competitiveness vis-à-vis foreign corporations on one hand and the government seeking to attract foreign investments to the county and would only be interested in legislative measures as long as these measures do not result in reducing the level of foreign investment into the country.

A second distinction is drawn between direct and portfolio investments in each of the two categories mentioned above (inbound and outbound).

In the context of outbound investments, the competitiveness arguments would appear to be more visible with respect to direct investments as opposed to portfolio investments because the former have a more direct link to the business of the corporation.

Another difference between portfolio investments and direct investments is that whereas direct investments are only available to domestic corporations with cross-border business activities, portfolio investments are also available to corporations that only operate domestically.[138]

In the context of inbound investments, it is necessary to distinguish among three different types of investment. The first type involves portfolio investments which countries are usually quite interested in attracting and would be relatively reluctant to impose any restrictions that might reduce the level of such investment, especially in light of the relatively mobile nature of these investments and their sensitivity to tax changes. These investments usually do not give rise to any competitiveness argument on the part of the resident corporations.

In contrast, the second and third types, direct investments, are different, as they require a balance between the desire on part of the country to attract foreign investment and the desire of domestic corporations to preserve competitive edge vis-à-vis foreign competitors.

In addition, in direct investments because of the related parties, tax considerations tend to become more important vis-à-vis other considerations. In most situations transfer-pricing legislation should address this distinction. This type of legislation, however, is not always effective.[139]

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[138] See also the equity discussion above (pp. 31-34).
[139] For example, equity notes (discussed below (pp. 141-144)).

A distinction is drawn between existing direct investments and new direct investments. The former are more focused only on the structure of the transaction whereas the latter are focused both on the location of the investment and on its structure.

A distinction further should also be drawn between measures, which are merely intended to put domestic taxpayers and foreign taxpayers on a level playing field and those, which are meant to grant domestic taxpayers a certain competitive advantage through the use of the tax system. The legitimacy of the former type can also be supposed by arguments based on efficiency and equity. However, measures from the latter type are likely to be regarded as unjustified restrictions and might at the long-term prove to be detrimental to the country adopting them by achieving the contrary result from the one originally intended.

This brings us back to the question of whether countries are willing to relinquish some existing benefits today in exchange for a better off overall situation tomorrow. It appears that the use of competitiveness as a policy goal can be treated as short-term thinking (short-sighted) satisfying long-term prospects for limited short-term benefits (gain).[140]

In addition, a tax policy based on competitiveness may have an adverse effect on other countries, mainly trade partners of the country adopting such policy. It would be naïve to believe that the adoption of such policy would go unnoticed by other countries, especially by trade partners and countries that are regarded as potential competitors of the country adopting the policy. This last point is addressed in greater detail below.[141] [142]

A possible explanation for some of the unwillingness on part of countries to restrict their policy only to economically valid competitiveness is the political element. As it is further discussed below,[143] tax policy is influenced by non-economic considerations, such as political considerations and other restraints that result from the structure and operation of each country and its institutions. These restraints can explain why some countries may prefer to adopt a policy that does not appear to be economically justifiable for the long term or adopting an apparently inconsistent approach with respect to certain planning opportunities. In that respect, ITA is no exception. This point is further explained below in the context of the case studies.

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[140] Refer please to the history of the withholding taxes on portfolio interest where a race to the bottom took place and nowadays it is quite common to have portfolio interest being exempted by many countries of source (see Avi-Yonah (1998c)).

[141] See also the discussion regarding tax competition (pp. 54-58 below) and Professor Graetz's arguments regarding the question of "beggar thy neighbor" (pp. 41-42 above).

[142] Please refer to the discussion below regarding the distinction between competitiveness and harmful tax competition (pp. 54-58 below).

[143] See pp. 65-72 below.

Summary

Making the connection between all the parts of the discussion above, we can reach the following interim observations:

First, policy decisions are made at the national level and with the intent of satisfying the self-interest of the country making these decisions. Yet, such decisions are made within the framework of existing principles and are by reference to policy decisions made by other countries.

Second, a distinction should be drawn between measures that are meant to create a competitive edge and measures that are designed merely to level the playing field and to neutralize the distortions that already exist in the markets.

Third, a distinction should be drawn between inbound investments and outbound investments and between passive and portfolio investments and active and direct investments.

Fourth, a distinction should be drawn between the competitiveness of the tax system and the competitiveness of taxpayers (Especially corporate taxpayers resident in the country). The former can also be achieved by reducing the compliance and administrative costs and making the system more efficient thus requiring less resources to be invested in the operation of the system leading to lower tax needed to be raised from the public at large. The result should be beneficial to all taxpayers in that country. Although there is an overlap between the two types of competitiveness, improving the latter may not necessarily result in any benefit to the country whereas improving the latter will most likely improve the competitiveness of the resident companies by reducing their tax burden (and possibly also reducing their compliance costs, at least in the country of residence).

Fifth, short-term measures should be distinguished from long-term measures. Sometimes, in order to improve the competitiveness of companies, certain measures are adopted. These measures, which might be influenced by other considerations,[144] may lead to a short-term benefit, which might prove as a long-term loss. If to use trade principles, it is possible to look at worldwide efficiency as being similar to free trade. As McDaniel noted,

"*From Adam Smith and David Ricardo on, the main principle of the economic theory of trade has been that of comparative advantage..... This principle highlights the fact that countries differ in their ability to produce different goods. If a country specializes in producing the good which it can do most efficiently and trading the good for other goods, all countries are better off and can attain a level of welfare unattainable in autarky... ...Hence, the economist's prescription for enhancing a country's welfare has been, for two centuries, free trade.*"[145]

Nonetheless, free trade may not always be a feasible option, or more precisely, will not be in the policy makers' best interests.[146]

[144] As for example, political considerations that are discussed below (pp. 67-71).
[145] McDaniel (2001) at 166.
[146] See the discussion below in the context of political considerations (pp. 67-71).

Chapter 3 – Additional Policy Considerations

Competitiveness, harmful tax competition & cooperation[147]

At the beginning of the discussion on competitiveness, I presented two types of competitiveness and moved to deal mainly with second level, the competitiveness of companies operating in the global world. At this stage, it is time to turn over to discuss some of the issues surrounding the first level, competition among countries.

A good way to illustrate the challenge is to use an example of a MNE, Intel, for example.[148] Although Intel is a US company, at least at the parent level, it has subsidiaries in many different countries and in most of these countries, if not all, Intel enjoys tax benefits which have important bearing on its decision whether to invest in that particular country. As a result, many countries, including developed countries, are engaged in a competition in an attempt to attract such MNEs like Intel to invest in their jurisdiction.[149]

There are several policies and arguments that revolve around one issue, the degree of cooperation and competition among the different jurisdictions in the area of taxation. The main question can be divided into two parts. First, what is the right balance between competition and cooperation among nations in tax matters and in what areas should one concept receive priority over the other. Second, to the extent that competition is good, how do we distinguish the good and contributing competition from the bad and harmful competition? In discussing ITA, a third question is added, where do we find ITA on the line between harmful and good competition? Is it part of the harmful competition measures and as such should be curbed or does it constitute good competition and thus should be allowed?

Ault describes this debate in the following way,

"*Some see tax competition as a good and healthy thing – it keeps the Hobbesian Leviathan in check, limits the state's tendency to expend, promotes more efficient governmental services, and limits political pandering to domestic interest groups.*

[147] Obviously, this issue is wide enough in its scope to provide for a full thesis devoted to it exclusively. In this short part I do not aspire to conduct any comprehensive or thorough discussion of the different policies and arguments but merely to raise a few of the opposing arguments and lay the foundation to the examination of the application of ITA in this context.
[148] This example is given by Avi-Yonah (2000) at 15.
[149] Avi-Yonah (2000) at 15.

On the other hand, there are those who see tax competition as resulting in a destructive "race to the bottom". Tax competition causes "bidding wars" in competing for mobile activities, ultimately resulting in no tax at all on mobile capital; it make redistributive non-benefits-based income taxation impossible; it may require states to shift to other revenue sources, force a reduction in capital expenditures to a sub-optimal level; it can prevent the implementation of democratically arrived at tax policy decisions as to tax mix and tax level, and generally leaves all countries worse off.

As in many situations which are characterized by polar views, there is an element of truth in both positions."[150]

According to Shaviro,[151] there are areas where competition and not necessarily harmonization is the appropriate policy that will bring the markets into a state of efficiency. A well-known theory supports the idea that to a large extent tax jurisdictions are very similar to private companies in the market place. According to this theory, *A Pure Theory of Local Expenditures*,[152] better known as the Tiebout Theory, to a large extent competition and lack of controlling monopolies or cartels is the appropriate way for tax jurisdictions to become more efficient and to avoid wasteful expenditures on part of the governments.[153]

This view (of tax competition) is shared to a certain extent by Shaviro, who regards international taxation as an area where (as opposed to tariffs) competition and not harmonization is the appropriate policy to follow.[154]

Thus arguably, any attempts to control competitiveness among nations in a way of multilateral agreements that would impose some sort of a pre-agreed tax burden on the participants (the taxpayers) would result in inefficiency and as such should be avoided.

Steichen, discussing the issue in a European context, argues that harmonization and cooperation can lead the smaller countries to waive and adapt their tax systems to accommodate the needs of larger countries that find it harder to complete with smaller countries, resulting in a "tax cartel" whereby the higher rate of taxation is imposed on the smaller countries thus preventing them from effectively competing with more developed

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[150] Ault (2002) at 2.
[151] Shaviro (2002).
[152] Tiebout (1956) at 416.
[153] *Ibid.* but cf Avi-Yonah (2000) at 1611 commenting on the compatibility of the Tiebout theory to international tax and in particular the freedom to move from one place to another and the limitation to benefit taxes which appears to be more problematic at the international level.
[154] Shaviro (2002).

countries. The risk of a "tax cartel" might also give rise to the leviathan argument according to which tax competition is necessary to contain and control government expenditure and expansion.[155]

In addition, Steichen is of the opinion that tax should be regarded as another element in the country's profile, just like its proximity to the markets, its population and its national resources.[156] Arguably, if some countries may use their geographical advantages to benefit their economy and attract investments, why other countries cannot do it by using fiscal incentives?

On the other hand of the competitiveness spectrum we have the well-known and often recited "*race to the bottom*" argument, according to which open and uncontrolled competition among different tax jurisdictions would lead many tax jurisdictions to a substantial reduction of their tax rates and as a result of their tax revenues, in a way that would damage the ability of some of these jurisdictions to finance their welfare policies.[157] [158]

This "*race to the bottom*" argument, however, is based on a premise that is not necessarily valid. It assumes that lack of co-operation in tax matters would necessarily lead to the same result obtained in the classic game of no co-operation, "the prisoner dilemma". It ignores governments' ability to make choices, which do not necessarily lead to reduction of rates or to harmful consequences.[159]

The major issue is probably the welfare state and the large existing and future liabilities that most of the developed countries (with US in the lead) have to include in their budget. This issue puts the more developed countries at a different level from the level of the developing countries as far as their minimum budget requirements are concerned.

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[155] Steichen (2003).
[156] *Ibid.*
[157] This is especially so with small tax jurisdictions that have very limited resources but are anxious to attract foreign investments to their territory, often at the expense of larger and more developed jurisdictions that cannot afford competing with the small jurisdictions, to a large extent due to the budgetary obligations they have towards their citizens. According to this argument, there are small jurisdictions, most of which are jurisdictions that provide no welfare or other similar benefits to their taxpayers, are able to afford a very low tax rate mainly because they do not have any obligations or do not propose to provide any social or similar services to their residents and citizens. These small jurisdictions are able to use what can be referred to as their low maintenance costs and attract tax revenues from more developed countries, countries that because of their social and welfare policies cannot afford to reduce their intake from tax revenues but are forced to due to the competition from these small jurisdictions which are free of these obligations. Obviously, supporters of competition may argue that this competition is a good reason for the more developed jurisdictions to revisit and reexamine their policies and priorities and to become more efficient as a result.
[158] It is questionable whether this concern should receive any particular attention.
[159] Radaelli (2003) at 151-152, discussing other responses governments might choose to follow.

The OECD and EU initiatives were based on the concept that there are some regimes or incentives that attempt to grant taxpayers the tax benefits without the latter "paying the price". In other words, one country attracts the income to benefit from it while the burden (the social benefits) is borne by another country. These regimes would usually include ring-fencing which is tax reliefs that are only offered to non-residents and are not offered to residents.[160]

In conclusion, tax competition involves not only disadvantages but also advantages. For example, tax competition may lead to control over government expenditure and the increasing of efficiency. It is more likely that countries with less welfare obligations and more efficient governmental sector that also seek a bigger share of the world's revenues would be more eager to engage in tax competition as a method to use their low governmental and social obligations in an attempt to increase their share of the tax revenues. Although it is possible that in the future the scope of the harmful competition would be wider and include query regarding the extent to which small countries should finance the costs of larger countries' social obligations, at present the focus appears to be on situations whereby one country is trying to offer tax advantages without bearing the costs.

"Thus another way of describing the problem is that under tax competition owners of mobile capital are able to benefit from the social arrangements their country supported by general government services without paying the social agreed cost."[161]

ITA, similar to harmful tax competition, raises some questions of competitiveness among jurisdictions and of the ability to substitute between jurisdictions, either completely or almost completely.[162] To the extent that there is complete or almost complete jurisdiction substitution, taxpayers are likely to prefer transactions with jurisdictions that would result in ITA and thus lower overall tax burden.

However, there are also some important distinctions from harmful tax competition. Unlike harmful tax competition, ITA is, to a large extent, not the result of a deliberate measure designed to attract foreign investments into the country, at low or no cost to the host country. ITA results from the interaction between the general tax laws of two or more jurisdictions, rules that developed over time independent of each other and operate independently which

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160 See generally the EU Code of Conduct of 1 December 1997 (published in the Official Journal of the European Union 6.1.1998 - http://europa.eu.int/eur-lex/pri/en/oj/dat/1998/c_002/c_00219980106en00020005.pdf).
161 Roxan (2003b) at 27.
162 See also, Edgar (2003).

might also partly explain the availability of ITA. As such it is not a specific measure and most like not an intentional measure but rather an unintended mismatch that turns out to the taxpayer's benefit. Yet, its consequences might prove to be very similar and although ITA is not included, to a large extent, within the definition of harmful tax competition, it is questionable whether ITA should receive similar response as harmful tax competition. Unlike harmful tax competition, in case of ITA, it is harder to isolate the part of the legislation that creates the ITA as it is part of the general tax system.

Absent harmonization, the reaction is likely to be a specific denial of benefits with respect to specific types of transactions. As it is discussed below,[163] in examining the experience of ITA in both the US and UK, it is possible to reach two interim conclusions. First, it is usually the country into which the investment is routed that would act to prevent the ITA. Second, a distinction is usually drawn between direct and portfolio investments. Countries that do decide to act against ITA would tend to do so with respect to the former but not with respect to the latter.

[163] In particular, see the discussion in chapter 8 below.

Revenue Loss

Prima facie, in ITA there should be a revenue loss because the taxpayer is enjoying (whether independently or with other parties) a tax advantage for free and, intuitively, someone has to bear the cost. That is, there has to be a loss to compensate for the free advantage. However, the situation is not always clear and the loss is usually not very easy to identify.

The loss is the result of taxpayers' ability to structure a transaction that achieves the same objective at a lower tax price (either a perfect or near perfect substitute[164]). This, however, is the view from a global perspective. There is a "global" loss because there is no matching at the global level and a transaction is structured to achieve a lower tax cost at the global level although at the narrow domestic level there is no revenue loss and the transaction is not subject to a lower tax burden than a similar transaction would in the absence of ITA (for example, a Hybrid instrument that is classified as debt for country X purposes will enjoy the interest deduction both when there is an ITA and where there is no ITA). Where there can be a loss is if the investment instead of being made in a way that would lead to also higher tax revenues is structured in a different way to benefit from the ITA opportunities.[165] As a result, the country manages to collect fewer revenues due to the change in the investment preferences.

If policy is determined at the country level and policy decisions are taken at the country level and the main rationale behind revenue loss is the potential harm to the losing country's revenue base without the advantage of a justifying benefit,[166] why should it matter if there is a loss in at the global level as long as no country suffers any loss as a result?

In that context, the following three questions should be examined.

A Revenue Loss or an Ultimate Revenue Gain

It can be argued, however, that while there might be a revenue loss when focusing on the direct tax consequences of the specific transaction, this might not be the situation if a broader perspective is adopted with respect to the transaction in question. There might be some related gains that would result from the transaction and from the fact that the transaction can

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[164] Edgar (2003).
[165] See also Edgar's argument on ITA as a low taxed substitute (Edgar (2003)).
[166] Arguably, if less taxes are collected – the burden is split among fewer taxpayers each required to pay more taxes as a result with the possibility of the country having less funds to finance its operations.

be conducted in this specific manner and with these specific tax consequences that would result in an overall revenue gain sufficient to offset (or even exceed) the alleged revenue loss.[167]

There might be some non-tax and even non-fiscal advantages that result from an ITA situation that have to be taken into account when the issue of potential revenue loss is discussed. It is quite possible that as a result of the ITA, certain non-tax advantages are achieved at the "expense" of the revenue loss. [168] Can these advantages, to the extent they exist justify the existence of ITA and any revenue loss that results from its existence? Can it be regarded as an incentive that would encourage and expand an industry that otherwise might not be that popular and thus create more opportunities for tax revenues that would ultimately offset the initial loss (a correction of a possible market failure?)? Connecting to our discussion above,[169] can it be regarded as a measure to correct the market failure thus arguably justifying the revenue loss, which might ultimately become a revenue gain?[170] Even if not, it is possible that despite the disadvantages, there is a justification for the revenue loss.[171]

The link to efficiency leads to another possibility, that the revenue loss is masked by revenue gain from other sources, thus becomes "invisible" in general reports and studies.[172] Avi-Yonah, while discussing the issue of revenue losses in the context of tax competition, refers to a recent OECD report on harmful tax competition and comments as follow,

"*The recent OECD Report on harmful tax competition argues that tax competition should be curbed primarily to prevent erosion of the revenue bases of OECD member countries. .... Unfortunately, the OECD Report contains no numerical data to bolster its claim that tax bases are eroding as a result of harmful tax competition. Aggregate data on tax collections, which section III.B reviews, do not support the claim: there is no evidence that overall revenue from the personal or corporate income tax in OECD member countries has declined*

[167] Quite similar to the "spill-over" argument regarding reduction of tax rate as a mechanism to attract new investments (or to generate more economic activity) - the increased revenues from other sources associated with the increase in investments and their volume are meant to compensate for the loss of revenues resulting from the reduction in the tax rate.
[168] For example, if granting a certain tax benefit (a cost to the country) would result in improving employment or expanding an existing under performing industry, Such industries would bring the country revenues that is not collected today thus cover (or even more than cover) the initial costs. See also the discussion regarding tax competition above (pp. 54-58).
[169] See pp. 25-26 above.
[170] Alternatively, should it be regarded as a protectionist measure harming free trade and the efficiency of the markets?
[171] Cf. the OECD survey on the justification for tax sparing provisions in tax treaties as a mechanism for attracting foreign investments (OECD (1998)).
[172] For example, increase in revenues from income from labor masking a decrease in revenues from capital.

as a percentage of either GDP or total tax revenues from 1965 to 1995. However, these data do not distinguish between revenue from labor and revenue from capital, and it may be that a decline in the tax revenues from taxing capital is masked by a rise in revenues from taxing labor. This hypothesis would be consistent with the findings on changes in the overall tax mix reported below in section III.B."[173]

Since a country needs to raise a certain amount of revenue to finance its public sector, the government will most likely be required to find other source of revenue to compensate for the loss of revenues from investments that benefit from ITA. If the government is successful in its quest for alternative sources of revenue, this might have the effect of disguising the actual revenue loss.

Whose Revenue Loss is it?

This discussion leads us to the second issue, whose revenue loss is it? An objection that logically follows in this context is that the revenue loss, even if it exists, cannot be assigned to any particular jurisdiction. As a result, we are left with an open answer to the question of who is worse off, which country loses from the existence of ITA, from this revenue loss.

If we examine the situation of double-dip leasing,[174] in both countries the taxpayers are able to enjoy tax ownership and its associated attributes. As a result of the asymmetry in the direction of the transactions (i.e. no or very few non-ownership leases or no very few taxpayer disadvantaged transactions) both countries allow tax depreciation with respect to the same property while only one country taxes the income that corresponds to these tax depreciations. Prima facie, at the global level, there is a revenue loss as there is no matching between the income and expenses (i.e. one deduction too many). Assuming such position is maintained, the question is who is the "loser" of the revenue in the case of ITA, if at all. Theoretically, if there is a global revenue loss, there has to be also a local revenue loss i.e. at the end of the day the loss has to be borne by at least one tax jurisdiction. But which one?

Does the Revenue Loss Warrant Intervention?

Assuming we accept the argument that there is a revenue loss (and assuming that it is possible to identify the country in every given ITA situation), we still have to determine whether this revenue loss warrants intervention on part of the losing country.

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[173] Avi-Yonah (2000) at 1597.
[174] This example is further discussed below (pp. 168-209).

This should be a question of cost and benefit taking into account not only considerations of efficiency, equity and competitiveness but also considerations such as foreign policy, political considerations and administrative feasibility.[175]

All these are further discussed below.

[175] For example, sometimes the country that suffers from the ITA is not the one that can react to it. A recent practical example to illustrate this issue is the Check the Box legislation in the US. As a result of the legislation, it became possible for many companies to assert a hybrid entity status i.e. to be taxed as a company in their country of residence and as a transparent entity in the US (or vice versa). While the country suffering revenue loss is not necessarily the US, the US is probably the country which is in the best position to act against the hybrid nature of these entities.

Unintended Result

According to Avi-Yonah one important distinction between harmful tax competition and ITA is that the latter was not intended by both countries. With harmful tax competition the outcome is intended, at least by one of the countries involved. Arguably, this is clearly not the situation with ITA where the taxpayer is using the interaction between the different tax systems to her advantage in a way that was not intended by either country. For that reason, Avi-Yonah argues that it is far easier to reach a consensus on curbing ITA than to agree on curbing harmful tax competition.[176]

Two questions should be asked at this stage.[177] First, does the fact that either country did not intend the outcome mean that there is a stronger argument against ITA (or in support of curbing ITA)? Second, does the mere fact that the outcome was not intended mean that it would be easier to achieve a consensus on curbing ITA?

Theoretically, this argument might be correct since the two countries did not intend the result that is achieved and therefore it seems that they will be more inclined to prevent this unintended result. This is especially true if our comparable is a situation whereby one country adopts a legislation aimed at attracting foreign investments while the other country, a capital exporter country, looks for ways to prevent its tax base reduction.

However, this argument assumes one important element, the behavior of the country that is "benefiting" from the ITA. Arguably, if one country is getting an advantage from the existence of the ITA (whether this advantage is direct or indirect) then this country might not be very anxious to give up this advantage, even if obtained unintentionally.[178]

Thus, it is possible that despite failing to take the possibility of ITA into account during the structuring and drafting of the tax system, once it realizes the benefits associated with ITA, the country might follow one of these two options. First, it might decide that the ITA in its existing version is in line with its overall international tax policy goals and as such allow it to continue and exist (Even though it was not planned in advance) or that it has no reason to object to its existence. Second, the country might realize that allowing ITA is inconsistent

[176] Avi-Yonah (1999-2000) at 173.
[177] A third question, what was the intended by the legislation is addressed separately below.
[178] This is especially if the current situation is inefficient and it is believed that ITA would lead to Pareto-optimum. Moreover, this argument should be regarded alongside other arguments above according to which a country may, on occasions, act even contrary to its self-interest in order to maintain some sort of other benefit (see my discussion above, pp. 44-46).

with its overall international tax policy yet allows it to exist because it furthers other certain tax or non-tax goals.

Chapter 4 - Practical Considerations

Below are, by way of introduction for a further discussion later in this work, three additional possible explanations for policy attitude of countries toward ITA. At this stage I shall only present the issues and not follow into a discussion regarding the merits of these explanations. This discussion will take place later in this work.

Foreign Policy

An important policy issue that is sometimes overlooked in the debate of equity and efficiency is the importance of foreign policy in determining international tax policy. The US, for example, uses its tax system to further certain foreign policy goals. From a neutrality perspective, the use of foreign aid or foreign subsidies is preferable instead of the use of tax incentives. By following the former the foreign policy goals are achieved while the tax system is unaffected. The support given to the foreign jurisdictions or to investments there is outside the tax system and from a pure economic tax perspective, this approach is usually preferable because it does not alter the effect of taxes on the participants in the market. Thus, for example, the US, as a policy matter does not allow for tax sparing provisions in its double tax conventions with other countries (whether developed or developing) despite the international norm in this field.[179]

In certain cases, however, granting subsidies or foreign aid outside the tax system is not practical or possible. For example, where a certain country is interested in deterring its taxpayers from investing in a certain foreign country. A good example is the way in which the US conducts its tax treaty policy and more recently, the expedient approval of the tax treaties with Australia, UK and Mexico following the war in Iraq and the support of these countries in the US position.[180]

Thus, foreign policy, instead of other tax principles or policies, is the reason behind the implementation / use of a certain tax measure or provision.[181] In that way the tax system may allow a country to make it more attractive for other countries to cooperate with it.[182]

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[179] Cf. the UK, which uses tax-sparing provisions in some of its tax treaties.

[180] In this respect it should be noted that part of the declared purpose of tax treaties is to further the relations between the two contracting states. In that sense, a tax treaty by its nature, is regarded as an implementation of foreign policy and not only of narrow tax policy. This is reflected not only in the decision to negotiate a tax treaty but more importantly in the substantive provisions of the tax treaty which may alter the tax consequences of a cross-border investment that is subject to the application of that tax treaty and may result in disparity vis-à-vis investment in other countries which are subject to the application of different tax treaties.

[181] Another example is found in the Subpart F rules and in particular the special implications of investments in countries that are on the list of boycotted countries, a list that is included in the regulations, (IRC §952(a)(3)(B) and §999).

In addition, following the above-mentioned concept of redistribution[183] using the tax system to further foreign policy goals can become more common. The questions to ask are whether the tax system is the place to apply such concepts and to what extent is it justified. With respect to the first question, economists and other followers of the efficiency principle will probably take the view that the tax system is probably not the place to implement such policies. Such policies, to the extent that they are warranted and justified, should be applied outside the tax system, for example, through the use of foreign aid. In such way, these policies can achieve both the goals of foreign policy on one hand and not hinder other tax policy and principles on the other hand.

Such approach, however, may not always be available or feasible. Moreover, since to a large extent, countries may regard the tax system as a legitimate mechanism to implement foreign policy goals, the use of the tax system for such purposes can be anticipated. Even though such use will probably hinder other tax principles and create preferences based on foreign policy considerations.

Once ITA is created, foreign policy might serve as a consideration in the decision whether to oppose or to allow ITA to continue and take place as such decision is likely to have foreign policy consequences.[184] Kane regards ITA as an opportunity for a country, like the US, to react by disallowing the benefits in a method that would serve as a positive signal to other countries of the country's willingness to cooperate.[185] Such an argument, however, assumes that intervention is justified and that signaling goes only in one direction. In some situations, however, signaling might not be beneficial for a country, because it would not serve as a justified policy, for example, with respect to inbound portfolio investment. Sometimes, foreign policy might dictate no reaction. A good example is when ITA exists in a transaction between the country and another country and the first country wishes to encourage and promote the trade relations with that other country. In this case, the act of disallowing the ITA might be regarded as a signal in the other direction contrary to the foreign policy objective of the first country. That is because such an act might be perceived by the other country as a disincentive for cross-border trade and even as an aggressive act meant to capture the revenue.[186]

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[182] For example, 2001 US – UK tax treaty, art. 10(3).
[183] See p. 35 above.
[184] See for example – Kane (2004) (arguing for the use of ITA as a signaling method in relation to other countries).
[185] *Ibid.*
[186] For the second possibility – see generally Shaviro (2002).

One last point that should be noted is that all the issues discussed above are relevant not only with respect to the structure and design of the country tax policies but also on the design and structure of other countries' tax policies. In that sense, it is not only the foreign policy objectives of a country that influence its tax policy decisions but also the foreign policy objectives of other countries towards the first country that affect their and eventually its tax policy decisions.

Political Considerations

> *"The collection of all those interests in this country represents what the political system is – and the political system creates the tax system. And that's why the tax system is sorta' like an inner tube that has been patched about 150 times."*[187]

Another important element that should be mentioned in this respect is the political element. As it was recognized long ago, taxation without representation is a tyranny and taxpayers, at least in a democracy, have the power to control tax policy or at least to scrutinize it, through the election ballots. A decision not to support a domestic company vis-à-vis foreign competitors may result in reduction in the work force of the domestic company and lead to ramifications on Election Day.[188]

In modern days, in addition to the classic representation, the ability to get elected is also affected by the presence and influence of pressure groups and lobbyists. Thus, companies, even in the absence of a right to vote, have influence on the way tax policy decisions are made. The influence, however, is usually with those who have the political power sufficient to influence and not necessarily with the public at large. A decision whether to allow or disallow foreign taxpayers to enjoy the benefits of ITA can be influenced by pressure from domestic companies no less than by considerations of revenue loss, efficiency or equity.

For example, throughout the last forty-some years since the introduction of the CFC legislation in the US, much of the legislation (including the original Act that was passed) was the result of a compromise between the different pressure groups and the approach taken by the Administration.[189]

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[187] US Representative Byron Dorgan (1986) quoted in Steinmo (1993) at 160.
[188] See the example above. As Funk comments in the context of the US FSC regime which caused upset in the EU, *"those measures annoy only Europeans, who do not vote in our elections"* (Funk (2001)).
[189] The business community in the US is quite powerful politically and examples for its activities in the tax area are the different reports that were published in recent years by institutions like the NFTC (for example, NFTC (2001). In addition, this was the initial reason for the adoption of measures against Canadian companies operating

Political considerations can also explain a decision by a country to support the conduct of certain activities by domestic operators although it might be more beneficial from a pure economic perspective, to move these activities to another country in the form of contract manufacturing.[190]

Political considerations are more significant where representatives stand for reelection after short periods in office, usually not exceeding four years. As a result, representatives would tend to focus on short-term gains and are less interested in long-term benefits, especially when such benefits can be achieved at the cost of short-term loss.[191] Unfortunately, this consideration is not always part of the discussion.

The literature both legal and economic on this subject usually divides into one of two possible approaches: public interest theory and public choice theory. According to the former, government seeks to improve general welfare and society whereas according to the latter, the resulting legislation is the result of well-organized interest groups, which operate to maximize the benefits of their members (including governmental officials and politicians).[192]

This relation between interest groups and politicians and its affect on tax policy, in its US context, is noted by Steinmo as follows,

"Most politicians would agree that the influence of special interest groups in America often undermines their desire to make good public policy. But the rub is that these same officials have a competing preference – they want to get reelected. Getting reelected requires the support of the interest groups.

Most elected officials have not abandoned their desire to make good public policy; they merely feel compelled sometimes to prioritize the competing preferences."[193]

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in the US that according to US businesses were able to use the inconsistency in the tax laws of both countries to improve their competitiveness vis-à-vis US companies.

[190] See for example, the FSC regime in the US, discussed above (pp.45-46).

[191] For example, improving the country's long-term economic outlook at the cost of moving activities that are conducted domestically to be conducted abroad thus freeing local resources to other more activities that are likely to be more beneficial at the long-term. In the short-term, the cost is loss of large amounts of work places and raising unemployment. In the long-term, the country will be better off because it is not able to maintain the conduct of the transferred activities without subsidizing these activities and moving these activities abroad would allow that country to buy the same services from abroad at a low price while being able to better invest its resources which were partially invested in financing the subsidy.

[192] Shaviro (1990) at 6-7.

[193] Steinmo (1993) at 198-199.

By contrast, in the UK, the structure of the political institutions together with the election system provide the elected government with a relative strong majority which makes the Parliament and its committees role in tax policy rather limited and puts most of this power in the hands of the elected government. As a result, it enjoys more freedom and has less need to engage in political negotiation to promote its agenda.[194] Nonetheless, despite its more solid status, the government still needs to ensure its reelection and thus some effect does exist, although clearly less than the one that exists in the US where the mechanism is much more decentralized and, as part of the system, the power is divided between the executive and the legislator and in the latter among a relatively high number of people.

Shaviro argues that public choice and public interest are not exclusive and they omit two important considerations that can explain certain events that cannot be explained through either of the above-mentioned approaches. In addition, Shaviro argues that the tax system is to a large extent at the mercy of outside events that prevent it from following a predictable path. In general, his argument seeks to establish that, despite attempts by different scholars from different disciplines, there are some important limitations on the ability to predict the outcome of tax legislation.[195]

The two considerations that are omitted from discussion are: first, that proposing and enacting legislation is a means of symbolic communication by politicians to members of the general public with the result that regardless of the outcome of the legislation, such communication can promote reelection.[196] Second, the legislative success is a method for exercising and demonstrating one's power.[197]

An important tool in this process is of course the media and the ability of politicians to use it as an effective means of communication. The media allows representatives to collect the profits of a legitimate act even if the specific legislation benefiting from such profits is not part of their actual agenda.[198] For that reason, tax planning that is attacked as inappropriate is not necessarily the one, which is more abusive than others. In many cases, the reason for the attack is the publication such planning received in the media, publication that lead politicians

[194] Steinmo (1993) at 200.
[195] As a basis for his arguments, Shaviro is examining the 1981 and the 1986 tax legislations in the US where an almost identical combination of personnel in decision—making positions led to completely different types of legislation.
[196] See also Enrich (1996) at 378 referred to by Daniels (2001) at 5 where one of the reasons mentioned for the popularity of tax incentives is the image factor, the desire of politicians to appear as taking care of their voters' interests.
[197] Shaviro (1990) at 8.
[198] Shaviro (1990).

to act, even though there might be other more abusive planning opportunities that are still to a large extent, private.[199] Only recently, in an attempt to regain some of the lost revenues, the UK Chancellor announced a crackdown on tax avoidance in the UK.[200] The advantage of such a move, apart from the economic and monetary advantages, is a perception that big corporations are not allowed to get away with creative tax planning and that the government is interested in making sure that the tax system is fair.

ITA is a classic example of good use of the media to gain political support. Looking "too good to be true" and being used mostly by able taxpayers (i.e. those who can pay the fee – either large corporations or wealthy individuals) ITA represents something that looks like a sophisticated tax avoidance scheme and would allow politicians to further their interests with their voting public. The only limitation is that these politicians would need to be cautious not to harm other interests, with interest groups for example, that might conflict with the first mentioned interests. When both the individual taxpayers and the big corporations are on the same side, the task becomes much easier.

The combination of political interests, interest groups, politicians seeking reelection and media can explain some of the debates on tax policy in the US. Two good examples are the debates on the use of domestic reverse hybrid entities by foreign investors and on the use of competitiveness of US corporations abroad. This point is well illustrated by the recent outsourcing debate. With respect to the debate in the US, it was recently commented,

"When a presidential election year coincides with an uncertain economy, campaigning politicians invariably invoke an international economic issue as a dire threat to the well-being of Americans. Speechwriters denounce the chosen scapegoat, the media provides blanket coverage of the alleged threat, and legislators scurry to introduce supposed remedies.

The cause of this year's commotion is offshore outsourcing – the alleged migration of American jobs overseas."[201]

One last point. A known principle of tax reform (and change in general) is that while those who benefit from the reform are not always identifiable, those who intend to suffer are not identifiable but also tend to be active in their objection. This principle helps to distinguish

[199] It is a known convention that for a successful tax planning to remain successful it must not reach the front page of the Wall Street Journal.
[200] Parker, BUDGET 2004: Big rush to crack down on abusive schemes, FT, Mar 19, 2004.
[201] Drezner (2004).

between a "desired reform" and a "practical reform". The former represents what should take place whereas the latter represents what will take place in practice. The more decentralized the legislature is, the bigger the difference is between what should take place and what actually takes place, as is also reflected in the quote at the beginning of this section.

Implementation

> *"Taxpayers have become global; tax authorities have not. They are necessarily national, or at best, they work bilaterally. Is it not obvious that tax authorities are fighting a losing battle?"*[202]

Two issues should be addressed. First, the feasibility and effectiveness of such reform. Second, the administrative costs of such reform.

The first issue discussed here focus on the feasibility and effectiveness of such reform. The first part relates to the first issue discussed in the previous paragraph. Thus, it is not sufficient that the reform is desired and required, it is also necessary that the reform is support or at least not objected politically. A good example is the different treatment given in the US to outbound use of hybrid entities and to inbound use of the hybrid entities.

In addition, there is no reason to adopt a measure that cannot be properly applied and implemented. That is, in deciding whether to implement a certain measure, it is necessary to determine whether the country is in a position to administer such reform.

For example, ITA. There are two problems associated with ITA in this context. First, it is necessary to identify the existence of ITA in a given transaction. In most cases, regardless of the validity of the transaction, the tax authorities are unable to scrutinize it simply because they are unaware of it whether this is due to lack of reporting (because a report is not requested/required), to the inability on part of the tax authorities to review the reports that are submitted or the inability on part of the tax authorities to identify the relevant transactions (this latter point is important in the context of ITA because the ITA nature of the transaction will normally not be revealed by only looking at the tax return of one party).[203] Second, it is necessary to ensure that the inconsistency is in fact ITA and not the result of

[202] Avery Jones (1999-2000).
[203] Due to these reasons, among others, tax legislation in both the US and more recently in the UK require taxpayers to identify for the tax authorities transactions that might fall into the class of tax avoidance, including in the US transactions that are treated inconsistently in two or more jurisdictions.

inconsistent reporting of the facts in the two jurisdictions. That is, that the inconsistency results from legal inconsistency in the treatment of a similar factual situation by the tax systems of the two or more countries involved and not from a factual inconsistency that results from improper reporting and has no legal basis.

Even if a country decides to retain ITA, it is still necessary to distinguish the real ITA situations from the false ones. For that purpose, it is necessary to identify potential ITA situations. That can be done through the use of extensive reporting requirements that oblige taxpayers to report and identify transactions that seek to benefit from an inconsistent treatment in two or more jurisdictions and by the use of developed exchange of information mechanisms among countries to validate and review the information submitted by taxpayers.

Thus, the challenge facing the tax authorities whether ITA is objected to or not, is the ability to identify and scrutinize ITA transactions. Any legislative consideration that fails to take into account this element would eventually be rendered useless. This bring us to the second issue that cost-benefit analysis is not only relevant to the direct revenue loss or revenue gain calculation but also to other policy questions, for example, the cost of compliance and the complexity of maintaining the system before and after the change.

Chapter 5 – Background to the Case Studies

United Kingdom

Overview

The British tax system which originated in 1799 with the first income tax imposed in 1803, is by many accounts, a complex system. The current system is probably best described as the outcome of the piecemeal legislation over the years. In the words of one commentator more than 30 years ago, "*[T]he British tax system was built on brilliant nineteenth century foundations, but years of piecemeal changes added to the complexity and detracted from the logical framework of the law.*"[204]

The system is built around the more than 200 years old schedular system (as opposed to the US concept of "catch all" income definition). An item of income that is not covered by the schedules is not subject to tax. In addition, since 1965, capital gains are also subject to tax by virtue of a separate Act of Parliament, alongside the income and corporation taxes. Until then, all receipts that were characterized as capital (as opposed to income) were exempt from taxes as they were not included in any of the schedules.

The UK tax policy was described recently as follows,

"The Government sees the primary aim of tax policy to be to raise sufficient revenue to pay for public services, while keeping the tax burden as low as possible. Tax policy needs to be based on clear principles. In the UK we see these as encouraging work, savings and investment. Fairness between all stakeholders is important, as is avoiding undesirable side effects and keeping compliance costs down.

We also need to pay attention to the UK's international competitiveness. We are committed to creating the best possible location for investment, to keep taxes on business as low as possible, and to ensure that the tax system reflects the modern environment. The focus of recent reforms has been to maintain a low rate, broad/ base system, to reduce distortions and market failures, to remove outdated restrictions and to counter avoidance."[205]

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[204] Chown (1971) at 1.
[205] Makhlouf (2001).

Tiley recognizes four limitations on current UK tax law: the schedular system that does attempt to tax what falls between the schedules, the distinction between income and capital, the many exceptions from the tax base and the courts attitude towards tax avoidance.[206]

The system does not tax persons but rather income. Nevertheless, for it to apply there has to be some type of connection between the income or person and the UK. In general, income that has its source within the UK is subject to tax regardless of the residency of the taxpayer. At the same time, income from sources outside the UK is subject to tax only if the taxpayer is resident in the UK.[207] This latter point, however, is too general especially with respect to the taxation of non-corporate entities.[208]

UK resident companies are subject to tax with respect to their worldwide income. In addition, controlled foreign corporations legislation is in place to ensure that the taxpayers do not try to avoid the application of the tax through the incorporation of a foreign subsidiary.

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[206] Tilley (2000) at 25.
[207] *Colquhoun v. Brooks* (1889) 2 TC 490 (HL).
[208] The UK tax system distinguishes between the concept of a "domicile", "an ordinary resident" and a "resident". Different rules of taxation apply depending on the type of classification the taxpayer in question qualifies for.

Tax Policy

According to the Inland Revenue, one of the important goals is to achieve a competitive tax system, which is also a fair system, a system that would attract investments into the UK and make the UK into an attractive place to be.[209]

The Inland Revenue continues and mentions six factors as features of a competitive tax system: a low rate and a broad tax base, neutrality, flexibility to accommodate and meet business realities and developments in both the business world and capital markets, consistency and coherency – taxing two transactions with similar commercial result alike and minimizing the distortions caused by taxation in the decision making process, transparency, and responsiveness to market failure.[210] In the process, the Inland Revenue intends to continue to remove outdated restrictions that exist in the tax system and to minimize tax distortions.[211]

A few years ago the Inland Revenue conducted a consultation process with respect to the appropriate system for double tax relief. In the course of consultation, the Inland Revenue reviewed the experience with the existing system of foreign tax credit and discussed the desirability of moving to exemption as the choice for foreign tax relief method, an alternative that was eventually not followed.

Prima facie, the combination of worldwide taxation, CFC legislation and the use of the foreign tax credit as a foreign tax relief mechanism would lead to the assumption that the UK is following a CEN as one of its policy goal. Not quite.

On one hand, the UK does not allow for a full foreign tax credit and thus technically, it does not follow CEN completely because its application of equal treatment to foreign and domestic investment is only to the extent that the foreign income is invested in a country that does not have a tax rate which is higher than the UK tax rate.[212]

In addition, the UK has quite generous foreign tax credit rules that allow for example for indirect foreign tax credit with respect to the taxes paid by the company distributing the dividend on its respective earnings.[213] This entitlement applies without limitation of tiers as

[209] HM Treasury & Inland Revenue (2003), at 2.
[210] *Ibid.*
[211] *Ibid* at 5.
[212] S.797 ICTA 1988.
[213] S.799-803A and 806A-806K ICTA 1988. This form of foreign tax credit should not be taken lightly as it constitutes over 4 billion pounds out of approximately 5 billion pounds of foreign tax allowed each year in credit.

long as it can be established that there is a link of holding of at least 10% of the shares of the lower tier subsidiary from the distributing company to the ultimate UK recipient seeking the benefit of the indirect foreign tax credit. In the domestic sphere, a dividend paid by a UK resident company to another is completely exempt from tax. While the end result of both measures might be the same, it is not always the case.[214]

On the other hand, the UK, which until recently allowed off-shore pooling in foreign tax credit computation, allows today a more limited on-shore pooling in the calculation of foreign tax credit. This technique allows UK resident companies with investments in low tax jurisdictions and in high tax jurisdictions to "average" the foreign tax paid to reduce the risk of excess foreign taxes and to use the foreign tax credit mechanism more efficiently.

Another distinction that exists is with respect to outbound operations in the form of a branch and outbound operations in the form a subsidiary. The general rule is that the foreign subsidiary's income should not be subject to UK taxation. The two main exceptions to this rule are situations where the subsidiary itself is subject to UK tax (either because it is considered as UK resident or because it has a permanent establishment in the UK) and situations where the income of the foreign subsidiary is subject to the application of the UK CFC legislation.

In discussing tax policy, an Inland Revenue official has pointed out several themes in the UK tax policy agenda.[215] First, raising sufficient money to fund the operations of the government. Second, promotion of fairness in the system. Third, paying attention to the UK's international competitiveness. In the process we should keep in mind the above-mentioned distinctions between fair competition and harmful tax competition and between measures that are designed to generate tax competition by improving the competitiveness of the taxpayers and measures that are designed to respond to tax competition generated by other tax systems.[216] This latter type of measure is now also subject to limitation imposed by the international community and more importantly by the European Union.

In the context of fair and harmful tax competition, while the UK is committed to curb the latter, it is also committed to follow the former in improving its system and making the UK

[214] Historically, the UK allowed also tax sparing as part of its treaties. Although some of the existing treaties still provide for such benefit, it appears not be part of existing practice.
[215] Makhlouf (2001).
[216] See the discussion on tax competition above (pp. 54-58) and also – Roxan (2003a).

the best possible location for investments.[217] This is done by either generating tax competition or by responding to existing legislation.

The UK is dependent on attracting foreign investments in order to maintain its economy and ability to satisfy its budgetary goals.[218] One of the features of the UK economy for many years is its significant amounts of inbound and outbound investments flows.[219] As a result, the UK has a strong interest in maintaining an appropriate and competitive international tax system that would encourage the continuation of these flows. In addition, it requires the UK to remain an attractive market for both foreign and domestic investments and as a favorite location for MNEs.[220]

The UK has low withholding tax rates with respect to interest and royalties (which can be reduced even further by an applicable tax treaty) and exempts dividends. Dividends and interest received by individuals are subject to lower tax rate.[221]The corporate tax rate has declined over the last decade to a rate of 30% today.[222] In addition, some of its generous foreign tax credit provisions were designed to be attractive to MNEs and to assist them to operate in the UK.[223]

For many years, the UK, in the absence of natural resources (apart from North Sea oil) based its prosperity on strong banking and insurance industries and as a center for financial investments and trading. With the establishment of the EU, the UK found itself on the same level playing field as countries like Germany and was required to improve its competitiveness in order to attract foreign investments and retain its edge. Thus, for example, in the context of capital gains, the UK took the approach of not taxing non-residents with respect to their gains regardless of whether the asset disposed of was located in the UK. A better example is the exemption granted to the investment funds management industry whereby gains and income of non-residents from investments are exempt from tax even though such investments were managed from the UK.[224]

[217] Makhlouf (2001).
[218] This ability might be undermined if potential claims for a refund of tax paid under a mistake of law are approved with respect to taxes paid under provisions that were later held incompatible with EC law. See Edge & Airs (2003).
[219] Chown (1971) at 21 and more recently Inland Revenue (1999) at 39.
[220] According to the Inland Revenue, UK direct investment earnings from overseas increased from 12bn in 1987 to 33bn in 1997. UK earnings from overseas portfolio income were 26bn in 1997 while the total investments of UK persons in 1997 were 595.5bn in portfolio overseas investment holdings and 226bn in direct investments. Regarding inbound investments into the UK, the amount of inward direct investment was $120bn in 2000 and only $28bn in 2002 (EIU).
[221] Discussed by Roxan (2003a).
[222] Roxan (2003a) at 488.
[223] *Ibid.*
[224] Roxan (2003a).

Similarly, despite ongoing debate, the UK retains the special regime for the taxation of non-domiciled residents ("remittance basis taxation").[225] Although, the regime applies with respect to individuals (mostly high net worth individuals with foreign source income), the regime makes the UK a favorable place to be for such people and as a result has an important effect on MNEs and large financial institutions who might be persuaded to move their headquarters into the country.

At the same time, this is not to say that there is complete acceptance of schemes that are perceived as abusive, at least by the Inland Revenue and Parliament. For example, the existence of strict transfer pricing rules, which starting in FA 2004 would apply, subject to certain exceptions, both domestically and cross-border and would replace to a large extent the thin-capitalization rules[226] and specific provisions dealing with income on transfer of assets abroad by individuals.[227]

Moreover, the Revenue has recognized the change in policies as a result of priority changes, changes that may make a scheme that was allowed a few years ago unacceptable today. As the Inland Revenue has commented,

"It may be that policies, however costly in tax terms, which were seen as defensible in this country in times of scarcity of foreign currency are not so readily defensible today. Companies are now free to buy foreign currency but there are good commercial reasons for sticking to the borrowing route. Capital has to be acquired somehow and the Eurobond and other Eurocurrency borrowing have become major sources. Also a borrowing in the same currency as that of the outward investment for which the borrowing is used gives protection to the investment from major shifts in value. A rise in the sterling equivalent of the borrowed funds is matched by a rise in the sterling value of the investment.

It is nevertheless a fact that the cost to this country in tax terms is high and the matter is kept under review. To attack relief on future outward investment linked borrowing would call for a specific purpose test and would involve the problem of identification – for what purpose was that particular borrowing used? Companies might be tempted to distort their borrowing patterns by financing a United Kingdom investment by foreign borrowing and leaving other

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225 Roxan (2003a) at 488.
226 This issue is further discussed below in the context of the impact of EC law on the UK tax policy.
227 S. 739-740 ITCA 1988, discussed by Roxan at 508.

accrued resources for outward investment. This might suggest more arbitrary tests none of which would be popular or easy to administer."[228]

A good example for this approach is the adoption of legislation to prevent the use of a planning that was commonly used during the 1970s – 1980s and which was referred to as the "Delaware Link", dual residence companies that claimed to be residents of both the US and the UK thus entitled to claim tax deductions in both jurisdictions.[229]

Another good example for this approach is the legislation surrounding the definition of a "distribution" for UK tax purposes and in particular, the specific legislation with respect to hybrid equity notes. This legislation is discussed below as part of the case studies.[230]

This approach is also evident in the new US-UK DTC, which includes two specific anti-planning provisions that were inserted at the request of the UK:[231] provisions designed to prevent the use of conduit arrangements and provisions designed to make less beneficial the use of repo transactions that are treated inconsistently in the US and in the UK.[232]

The distinction in treatment can be explained in part in the distinction between direct and portfolio investments. On one hand, it appears that foreign portfolio investments are usually encouraged and the UK has established a relatively attractive system for non-residents who are interested to invest in the UK. This treatment includes low or no withholding taxes imposed on income and gains from portfolio investments (either by domestic law or by an applicable tax treaty), all of which makes the UK an attractive investment location for non-residents. In addition, the relatively low tax imposed on such income may assist in making the financial markets more attractive to foreign investors, increasing the liquidity of these markets and making the raising of capital cheaper and assisting UK based companies to raise money to finance their operations, making them more competitive.[233]

The situation appears to be more restricted with respect to direct investments and especially financing aspect of direct investments, where the UK has restricted the application of certain

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[228] Inland Revenue International Tax Handbook, ¶1208.
[229] S. 404 ICTA 1988 introduced simultaneously with the introduction of IRC §1503(d) in the US.
[230] See pp. 141-144 below.
[231] The anti-conduit arrangement provision is in Art. 3(1)(n) and Art. 23(4)(c). With respect to the former, for the first time in the UK treaty practice, the treaty includes both a anti-conduit arrangement provision and a limitation-on-benefits clause. This reflects the different approaches taken by the US and the UK with respect to prevention of tax treaty abuse (Inland Revenue (2003)).
[232] Art. 23(4)(c).
[233] Although this can be one of the reasons, there appears to be no indication that this is the express intention behind the legislation. Compare – the US policy discussed below (pp. 96-113).

tax advantageous financing methods.[234] This more restricted approach can be explained by a desire to maintain the competitiveness of UK based multinationals on one hand (allowing such transactions might result in foreign based multinationals' ability to raise cheaper finance due to the tax advantage) and by the premise that a financing transaction between related parties is more likely to be motivated by tax considerations. Foreign direct investments fall into this category.[235]

[234] See, for example, the equity notes legislation in 1992.
[235] This is part of the investment v. ownership balance that is further discussed below (pp. 221-235).

The European Union

With the decision to join the European Union (EU / EC) the UK has waived certain elements of its fiscal sovereignty. While the theoretical waiver took place many years ago, for many years, the UK continued to plan, to a large extent, without taking the EU and its tax policy into account.[236] For example, many of the provisions dealing with export leasing that are discussed in more detail below,[237] were adopted during the 1970s and amended again in 1997 and are potentially in violation of EC law principles. Similar examples are the 1992 equity notes legislation and more recently, certain provisions of the 2001 US-UK DTC whose validity under EC law is uncertain.[238]

Although the UK tax legislation was changed in recent years, partially as a result of ECJ decisions,[239] it was only recently that EC law became a relevant consideration in UK tax legislation process. In its 2003 Consultation paper, the Inland Revenue amended its past failure to address the issue and referred to the need to comply with EC law requirements as part of the considerations that led to the abolition of the thin capitalization rules and the introduction of new transfer pricing rules that would be applied both domestically and internationally.[240]

"The previous year's offering, in August 2002, had failed to address the big issues of the moment, the impact of International Accounting Standards and the effect of the European Court judgments. 2003's consultative document does face up to those issues, at least in some degree, but attempts to discreetly close the door when the horse is already half out of the stable."[241]

The discussion of EC tax policy should be divided into two main parts, internal tax policy relating to the establishment and operation of the internal market and external tax policy guiding the EC tax policy vis-à-vis third countries.

With respect to the latter, in a recent communication, the Commission has announced the following two goals. First, to stop the erosion of certain types of tax revenues, in particular,

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[236] To a certain extent such approach can be justified as being a pragmatic and practical approach that sought to minimize, in absence of positive direct tax legislation, the possible negative effect of ECJ decisions on the system. It appears that the court's approach in *Saint Gobain* to subsequent changes of domestic law to comply with EC law can be seen as supporting the UK "wait and see" approach.
[237] See pp. 197-203 below.
[238] See generally, Clark (2003) and Craig (2003).
[239] For example, the change to UK group rules as a result of the ECJ decision in C-264/96 *ICI v. Colmer*, and the extension of DTC application to cover branches following the ECJ decision in C-307/97 *Saint Gobain.*
[240] HM Treasury & Inland Revenue (2003), chapter 3, at 15-18.
[241] Troup (2003).

those revenues from taxes on capital. This goal is in line with the EU participation in the OECD Harmful Tax Competition initiative and its publication of the "Code of Conduct" as part of its own initiative against harmful tax competition. Second, to "*improve the competitiveness of European companies and to become the most competitive and dynamic knowledge-based economy in the world.*"[242]

Internally, the focus has been and is still, to establish and operate an efficient common internal market. This goal is set forth in Art. 2 of the EC Treaty,

"The Community shall have as its task, by establishing a common market and an economic and monetary union and by implementing common policies or activities referred to in Articles 3 and 4, to promote throughout the Community a harmonious and balanced and sustainable development of economic activities..."

For that purpose, Art. 3(1)(c) provides that "*an internal market characterised by the abolition, as between MS, of obstacles to free movement of goods, persons, services and capital.*"

The history and probably much of the present state of European taxation with respect to harmonization or even co-ordination in the area of corporate taxation is probably best illustrated with the following quotation

"There have been a number of detailed reports examining the lack of harmonization of corporate income taxes in Europe and the resulting problems and suggesting potential solutions. Despite these efforts, there are still 15 different corporate tax systems operating within the EU. ...It is extremely difficult to quantify the costs that the lack of harmonization, or even co-ordination imposes upon the Union. And harmonization, or even co-ordination requires individual governments to relinquish control over at least part of their ability to raise tax revenue. To date, European governments have not demonstrated great enthusiasm for corporate tax harmonization, and earlier proposals for greater co-ordination of corporate income taxes within the EU met with considerable resistance. However, the recent growth of international policy initiatives on business taxation indicates a desire to address at least some of the issues that have been causing concern."[243]

[242] COM[2003] 726 final at 3 referring to point 5 of the Presidency Conclusions from the Lisbon European Council 23 and 24 March 2000.
[243] Bond et al., (2000).

The EC Treaty includes very few provisions dealing specifically or explicitly with taxation and with direct taxation in general. Of these few rules, Art. 94 provides that any positive legislation in fiscal matters shall be made only by unanimous agreement of MS. This provision has the effect of retaining the power to tax and legislate on tax matters in the hands of MS, unless such power is unanimously exercised by the EC in accordance with the provision of Art. 94.

At the normative level, EC law impact on MS in the direct taxation matters can be divided into three groups.

First, positive legislative initiatives either in the form of directives that are binding on MS and are also directly applicable to MS tax systems even without a formal act of incorporation into their domestic legislation,[244] in the form of conventions that are binding on MS but are not directly applicable, or in the form of soft legislation, guiding principles rather than binding commitments.

Second, ECJ case law applying the provisions of the EC Treaty. The EC Treaty does not include many articles dealing specifically in taxation issues. However, Art. 12, which provides the general principle that there should be no discrimination on the basis of nationality and Art. 23, 39, 43/48, 49, and 56,[245] which provide the rules of the Treaty freedoms, freedoms that should be maintained based on the general principle in Art. 3(1)(c) above. The ECJ, in applying and interpreting the EC Treaty with respect to direct tax issues, has found that the EC Treaty freedoms in Art. 23, 39, 43/48 and 56 (and to a more limited extent also the non-discrimination requirement in Art. 12) apply to direct taxation questions, despite the absence of express reference in the EC Treaty to direct taxation.[246]

Unlike the situation in indirect taxation where to a large extent tax sovereignty is kept at the EU level, MS retain the discretion of how to structure their national tax system and whether to shift the tax burden from direct taxation to indirect taxation and vice versa.[247]

The ECJ has recognized that while MS retain sovereignty and discretion in most direct tax matters, these powers have to be exercised in accordance with the principles of EC law and subject to the provisions of the EC Treaty as interpreted by the ECJ and avoid any overt or

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[244] EC Treaty, Art. 94.
[245] Freedom on the movement of goods, of workers, of the right of establishment, of services and of capital, respectively. These principles are further discussed below.
[246] Schon, (2002) at 97 referring to a series of decisions, and fundamentally, C-270/83 *European Commission v. France* (Avoir Fiscal).
[247] Schon (1999) at 915.

covert discrimination on the basis of nationality.[248] As a result, the discretion of MS in tax matters when it is necessary to distinguish between domestic and foreign persons became much more restricted,[249] as MS may not impose discriminatory tax measures on nationals of other MS and may not impose tax measures that constitute restrictions or barriers to the exercise of the EC Treaty freedoms or which make the exercise of these freedoms less attractive.[250]

Third, Commission communications and ECJ case law on state aids, which are prohibited under the EC Treaty Art. 87.

The impact of the first group is relatively restricted, mainly due to the unanimous voting requirement for the issuance of directives dealing with fiscal matters. In the years since 1960, the activity in the area of positive legislation in direct tax matters under the authority of Art. 94 has been very limited. For many years there was no legislation in the area[251] and even today, these positive measures including the parent-subsidiary directive, the merger directive and more recently the interest and royalties directive and the savings income directive.[252] In addition, there is the Arbitration Convention (for the resolution of transfer pricing disputes between MS) under the authority of Art. 293. Its use, however, has been very limited.[253]

The impact of the second group has been significant and to a large extent was not anticipated by MS. In the vacuum that remains in the light of the inaction under the first group, the ECJ has taken the initiative and in approximately forty direct tax decisions (and some important non-tax decisions), changed the way EC law is perceived by members of the tax community.

The third group, the prohibition of State Aids, has developed relatively more slowly than the second group and only a few years ago the Commission announced its intention to focus more on the application of the rules prohibiting state aids.[254] Nonetheless, the prohibition of state aids is increasingly important consideration in tax policy and legislation considerations.

[248] C-270/83, *Avoir Fiscal*; Gammie (2003).
[249] Schon (1999) at 916.
[250] *Ibid.*
[251] With the exception of the limited directive on capital duty that was adopted in 1969, it was only in 1990 that two additional directives (and one convention) were adopted. Even today, there are very few directives in force and their scope is rather limited to specific situations. The tax base is far from being harmonized or even coordinated.
[252] Dir 90/435/EEC (Parent-subsidiary), Dir 90/434/EEC (mergers), Dir 2003/48/EC (Saving) and Dir 2003/49/EC (royalty and interest).
[253] Until today, the convention was used only once, in 2003.
[254] European Commission, Commission Notice of 28/11/1998 OJ 1998 C 384/34.

The existence of fifteen different tax systems with fifteen different approaches to the taxation of income creates distortions as each state is trying to tax the same income but doing so in a different way.[255]

While acknowledging that it is likely that the community would be better off if MS were able to agree on a common approach with respect to the taxation of income, scholars argue that they will only do it if each MS believes that it can maintain or increase its tax revenues.[256] Such agreement would benefit the community as a whole as it would result in lower tax burden in terms of costs of distortion, jurisdiction and enforcement.[257]

The historical development of the EC direct tax policy establishes a move from harmonization attempts towards a more practical, limited and pragmatic approach. Two of the main obstacles in adopting a clear policy in the direct tax area are the differences in approach among MS with respect to the method of computing and calculating the taxpayers' profits and income and the need for unanimity for the adopting of positive direct tax measures.[258]

The application of the EC Treaty by the ECJ

In the absence of an agreement among MS regarding direct tax policy in the internal market, the ECJ is exercising its jurisdiction to implement the provisions of the EC Treaty on the MS competent authority with respect to direct tax legislation. In the course of exercising its jurisdiction, the court is applying the non-discrimination requirement and interpreting the treaty freedoms in a wide and liberal way while adopting a narrow and restricted approach to possible justifications that are raised by MS.

The EC Treaty Art. 12 prohibits any discrimination of the basis of nationality. In addition, Art. 39 prohibits any limitation of the free movement of persons in the EU, Art. 43 and 48 prohibit any limitations of the freedom of establishment in the EU, Art. 49 prohibits any limitations of the freedom to provide services in the EU and Art. 56 prohibits any limitations on the free movement of capital in the EU (hereinafter: the "Four Freedoms").

[255] Gammie (2000) at 42:2.
[256] *Ibid*, at 42:3.
[257] *Ibid.*
[258] Prats (2002).

Art. 12 is generally considered as an independent section whose application is not dependent upon the application of any other section. Nonetheless, when another prohibition is applicable, it takes precedence over the general non-discrimination prohibition of Art. 12.

In discussing the Four Freedoms, commentators generally divide the prohibitions into two main groups, discrimination and restrictions/barriers on access to the market. The former usually applies to situations examined from a host country perspective whereas the latter applies to situations examined from an origin country perspective, although it is possible to analyze most of these decisions also on the basis of non-discrimination.[259]

Discrimination exists where two persons in objectively comparable situations are treated differently or when people who are in objectively different situations receive the same treatment.[260] Discrimination can be either direct (overt) or indirect (covert).[261] The latter type has been described as occurring when the application of criteria of differentiation (other than nationality) leads to the same reason achieved in situations of overt discrimination. The acceptance of covert discrimination has resulted in the criteria of tax residence being included as relevant criteria as non-residents are more likely to be residents of other national states. As a result, where the legislation treats non-residents who are in objectively comparable situation differently than residents, there is discrimination.

For discrimination to take place the situations must be objectively comparable. Although in general the situations of residents and non-residents are not objectively comparable, especially in the case of individuals, there are limited situations in which residents and non-residents might be considered to be in objectively comparable situations.[262]

While discrimination is relatively easy to identify and deal with from the perspective of the host state, the situation might be more complicated where the comparison is made from the perspective of the state of origin.

However, as the ECJ case law establishes, the Four Freedoms should be maintained even in the absence of a discriminatory treatment.[263] Thus, when a domestic provision (Whether or not discriminatory) imposes a restriction on the exercise of the EC Treaty freedoms by a state's own nationals/residents or would result in making the exercise of such freedoms less

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[259] Layl (2003).
[260] C-381/90 *Shumacker.*
[261] C-152/73, *Sotgiu.*
[262] C-307/97 *Saint Gobain* and also C-381/90 *Schumacher,* C-80/94 *Wielcox* and C-107/94 *Assher.*
[263] C-118/96 *Safir,* discussed by Terra & Wattel, at 42.

attractive than operating domestically, the provision must be amended, unless it can be justified.

Restrictions that are the result of a disparity between the tax systems would not amount to an allegedly prohibited restriction even though the outcome might be that cross-border transactions are less attractive than domestic transactions.[264]

As Gammie points out, a MS may defend its stand by establishing one of the following two arguments: first, the situations in which the taxpayers are in are not objectively comparable. Second, there is a valid justification to distinguish between the objectively comparable situations.[265]

Things become more difficult when the court is required to choose between the two comparable situations. The situation arose in the case of *Marks & Spencer*.[266] The UK Special Commissioners applied the principle of territoriality justifying the grant of loss relief to UK subsidiaries of a UK parent while denying similar relief to non-UK subsidiaries of the UK parent. According to the Special Commissioners, applying the principle of territoriality, the two situations were not objectively comparable and different treatment may thus be justified. The decision was appealed to the High Court that allowed a reference to the ECJ where the case is now pending.[267]

A Brief Analysis of the case law

One thing that is clear from the ECJ case law is that the treatment of the counter-party to the transaction is irrelevant[268] and the fact the transaction or a person is able to enjoy an advantageous treatment in one MS is not a valid justification for treating him disadvantageously in a second MS.[269]

"Any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another

[264] C- 336/96 *Gilly*.
[265] Gammie (2003).
[266] C-446/03 pending.
[267] cf. Lyons (2003) who is of the opinion that the Special Commissioners confused the principle of territoriality with the question of whether the two situations were objectively comparable. See also A-G in *Bosal* who found that the two compared situations must be looked at from the perspective of the origin state taxpayer only. For an analysis of the case from a UK perspective, Evans (2003); For an overview of different possible approaches, see generally the articles in *EC Tax Review* 2003/3 and in particular Gutmann (2003).
[268] C-294/97 *Eurowings*.
[269] *Ibid.*

Member State to justify less favorable treatment in tax matters given to recipients of services established in the latter State."[270]

Early case law focused on the existence of discriminatory treatment as a basis for the ECJ intervention and for the application of the EC Treaty. While Art. 12 does not apply if one of the other freedoms is restricted in any way, Art. 12 and the question of discrimination was usually the starting point in the discussion by the court. More recent case law, starting in 1997, has shifted to focus to questions of restrictions on market access. Nonetheless, many cases may be interpreted as based on either basis.

A conclusion that a given situation is regarded as discriminatory or involving a restriction on market access, does not automatically lead to violation of EC law, as it might be possible for the MS to justify the discrimination or restriction. Where the issue at stake involves an overt discrimination, then the only justifications allowed are those specifically mentioned in the EC Treaty.[271]

Where, however, a restriction to market access takes place, other justifications, in addition to those mentioned in the EC Treaty, may be allowed.

These justifications include the following: the measure is meant to pursue a legitimate aim that is compatible with the EC Treaty, can be justified by reason of public interest.[272] For example, situations of fiscal cohesion,[273] prevention of tax evasion[274] and fiscal supervision.[275]

In the course of the years, the ECJ has rejected the validity of several justifications including loss of tax[276] and prevention of national tax avoidance[277]

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[270] *Ibid.* Also referred to by Terra & Wattel (2001) at 81.

[271] These are – public policy, public security and public health (Art. 39(3)).

[272] The court formulated four conditions necessary for a successful application of this justification: (1) the measure must be applied in a non-discriminatory manner (2) it must be justified by imperative requirement in the general interest (3) it must be suitable to achieve the objective, and (4) it must not go beyond the necessary to achieve such goal (C-55/94 *Gebhard*).

[273] *Bachmann* C-204/90 but cf. C-251/98 *Baars*, C-35/98 *Verkooijan* and recently C-136/00 *Danner*; although *Bachmann* established the existence of this exception, later case law significantly restricted its application. To successfully apply the exception the MS has to establish a "direct link" between the income inclusion on one hand and the expense allowance on the other. For that purpose, it has to establish that it is the same taxpayer and the same tax that is involved (C-35/98 and C-251/98). For a recent discussion by the court, see C-168/01 *Bosal Holding*.

[274] C-264/96 ICI v. *Colmer* cf. limited application in C-324/00 *Lankhorst-Hohorst.*

[275] First recognized in an indirect tax law case (C-120/78 *Cassis de Dijon*) and accepted in C-250/95 *Futura* but subject to the requirement of proportionality cf. C-136-00 *Danner*. It should be noted that the proportionality standard applies as a general requirement and not solely in the context of fiscal supervision.

[276] C-324/00 *Lankhorst-Hohorst.*

The court was reluctant to hold that several legislations, originally introduced by MS to prevent their tax base erosion and to curb tax avoidance, have been inconsistent with EC law principles to the extent they discriminated against non-residents or restricted access to the market by favoring domestic investment to cross-border intra-European investments.[278]

An interesting point is the lenient approach taken by the court towards tax abuse. This is compatible with the approach to abuse in other areas (non-tax).[279] In a series of tax cases as well as non-tax cases, the ECJ has established a very liberal approach with respect to tax abuse, indicating that it might serve as a justification only in restricted situations. Not only that. According to Terra and Wattel, it appears from the case law that tax jurisdiction shopping within the internal market is considered to be a legitimate activity even where the sole reason behind the arrangement is to circumvent unfavorable domestic tax rules.[280]

In the absence of any clear legislative guidance from the Community Institutions regarding direct tax policy, it appears that the ECJ will continue to exercise its jurisdiction in full.

In applying the fundamental freedoms consistently and impartially the ECJ is demonstrating qualities that are essential to courts in any system of justice...... If the Member States regard the fundamental freedoms as corrosive of their tax systems, let them take the opportunity presented by the drafting of the European constitution to change the situation."[281]

At present, absent agreement, there appear to be two broad paths for MS to follow. MS can either apply domestic tax rules also with respect to cross-border transactions (at least at the EU level with other MS) or they can apply their international tax rules domestically. Otherwise, existing domestic tax legislation might not stand the ECJ scrutiny.

The main problem with ECJ decisions is the lack of clarity resulting from them. The absence of dissenting opinions in the court's judgments and the court's refusal to explain thoroughly the basis for its decisions or to address questions that are beyond what is specifically required to reach a decision on the factual situations it is presented with, make it possible to have more than one interpretation to the court's approach and leaves many unanswered questions open.

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[277] Tax avoidance would be allowed only if the provision is narrow enough and specific enough to target only situations of tax avoidance.

[278] See generally, C-324/00 *Lankhorst-Hohorst* (German Thin-Capitalization rules held to be inconsistent with EC law).

[279] See generally C- 212/97 *Centros*.

[280] Terra & Wattel, at 81-82. They infer from the case law that the court will probably only accept the abuse argument if disregarding the tax effect, the arrangement is completely artificial (at 83).

[281] Lyons (2003) at 449.

The heart of the conflict seems to be as follows. On one hand on the insistence on part of MS to continue to legislate and design tax policy and rules based on the difference between national residents and non-residents, the border is laid in accordance with the national borders. On the other hand, the ECJ insists on applying the EC Treaty consistently with the view of one internal market with seamless national borders thus eliminating any barriers along national borders (the seamless national borders approach).

The ECJ mandate is to eliminate the obstacles to the creation of one internal market. For that purpose, the ECJ is applying the non-discrimination provisions and the treaty freedoms from two perspectives, an origin country perspective and a host country perspective. In both situations the ECJ will apply the EC Treaty to ensure that cross-border transactions are not discriminated against or that there is no obstacle or restriction that would make the cross-border transaction less attractive than a domestic transaction. From a neutrality perspective, one can argue that the ECJ apply the CIN principle to situations that are examined from a host country perspective and the CEN principle to situations that are examined from an origin country perspective.[282] Thus, the ECJ is trying to establish an equal level playing field for both domestic transactions and cross-border intra-European transactions. This, however, is not completely accurate.

While the ECJ, in exercising its powers in the light of the EC Treaty purpose, is interpreting and applying the EC Treaty to ensure that there are no obstacles or restrictions on cross-border transactions within the EU, it does it in one direction only. This limited application can result in favorable treatment to cross-border transactions over domestic transactions. Thus, for example, in examining CIN in the context of the host state, the court is not looking into the treatment of the non-resident in its state of origin. Moreover, even if in the overall European result (combining the treatment in both the state of origin and the host state) the non-resident would be in an advantageous situation as a result of a level playing field in the host state, the host state cannot use this as a justification for a disadvantageous treatment of the non-resident by the host state vis-à-vis residents.[283] Thus, in effect, the court in its analysis employs a very limited concept of neutrality.

"Any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another

[282] Terra & Wattel (2001) 4.2.2.
[283] See, for example, C-175/88 *Biehl* and C-294/97 *Eurowings*.

Member State to justify less favorable treatment in tax matters given to recipients of services established in the latter State"[284]

In addition, the ECJ does not intervene in situations where in either the host state or the state of origin (without taking into account the situation in the other MS, respectively) a cross-border transaction is treated in a more favorable way than domestic transaction. Similarly, the treatment of the other party to the transaction or the treatment of the transaction in another MS is usually irrelevant for the application of the non-discrimination and freedoms provisions.

Furthermore, because both CEN and CIN can simultaneously co-exist only to the extent that the tax rates in the relevant jurisdictions are the same, in the absence of rates equality in the EU, the application of the EC Treaty by the ECJ will not (nor does it seek to) result in overall neutrality.

Prima facie, it appears that the ECJ case law creates some sort of a breeding ground for ITA, where ITA is not being targeted by the court as a prohibited measure and more than that, MS might find their attempts to eliminate ITA being regarded as a prohibited discrimination or restriction under the EC Treaty.

In the context of the UK, the number of pending cases before the ECJ is increasing and there are already several examples of the impact of ECJ case law on its legislation. It seems that there are three main paths in which the UK is going. First, with respect to certain measures that were specifically held not to be in compliance with EC law, the UK legislation has changed. Second, with respect to other measures that were held not to be in compliance with EC law, the UK has chosen unilaterally to adopt legislation that would make its legislation compatible. Third, with respect to other measures that were not discussed but whose compatibility is doubtful, the UK has chosen to do nothing. With respect to measures coming under this third group, it appears that it is only a question of time before these measures would be covered under the first group mentioned above.

"With news of yet more ECJ cases challenging the UK's CFC rules and the basis of taxing foreign dividends and relieving losses, the most puzzling thing is that there is no acknowledgement that a problem might exist in these, or other, areas. ... It is unlikely that the silence on these issues is a sign that the Inland Revenue are supremely confident in the

[284] C-294/97 *Eurowings* quoted by Terra & Wattel (2001) at 81.

strength of their case. If the outcome of these cases is, as it must be, uncertain, the Chancellor appears willing to gamble taxpayers' billions on the results of litigation."[285]

Things might be even worse, as the chances to win the "bet" are even slimmer.

From a policy perspective, although huge uncertainties remain with respect to the long-term impact a few preliminary assertions can be made with respect to the possible impact of the EC Treaty and ECJ case law on UK tax policy and legislation. First, although the UK is more closely related to CEN as a policy goal, if the ECJ continues with its application of the EC Treaty, it is likely that the UK would be led to adopt a CIN approach, while replacing the foreign tax credit with an exemption method as it foreign tax relief mechanism. Second, a policy goal of preventing UK revenue loss may not longer be feasible, at least not when it contradicts the provisions of the EC Treaty. The only apparent alternative available to UK policy makers is to follow the second option mentioned above and adopt international tax rules to domestic situations as well. The downside is that such policy choice might entail higher compliance and administration costs that would impact on the competitiveness of the UK companies and of the tax system that according to the Inland Revenue are at the center of the current discussions on the corporation tax reform.[286]

Third, the fiscal cohesion argument in its current status appears to be too narrow to apply in most situations.

In addition, to add to the effect of the above-mentioned case law, a MS might be liable for damages in case of non-compliance with EC law. In the UK, many claims have been brought to claim refund of tax paid under the (wrong) understanding that such tax was actually due when it was later discovered, following decisions of the ECJ, that the legislation in question was incompatible with EC law.

The mean issue at stake is the period of limitation that exists with respect to such claims and when does the count towards the period of limitation begin. This issue is presently before the High Court in the UK pending decision.

If the applications are successful, the UK might be required to refund tax paid back to taxpayers with the possibility of going back to the taxable year in which the UK joined the

[285] Troup (2003).
[286] The other alternative is for MS to amend the EC Treaty to include protection of national revenues as a valid justification for adopting discriminatory and/or restrictive tax measures which is probably not feasible. Troup (2003).

EU (the EEC), that is 1974. In such case, the UK might find itself in desperate need for tax revenues, a need that is likely to affect its approach to tax planning.[287]

The prohibition on State Aids[288]

Another important limitation of the tax sovereignty of MS is the restriction on state aids in Art. 87(1). This measure, whose applications can be quite wide, is not always appreciated in policy discussions.

In 1998, the EC Commission published a notice including guidelines to the application of the State Aids rules.

For the prohibition of Art. 87(1) to apply, the following requirements have to be satisfied:

- There has to be an aid
- The aid has to be from the state or through its resources
- The aid must have result in a distortion of the previous situation
- The aid must be selective in nature – it has to be granted in favor of "certain undertakings or the production of certain goods."

Thus, it is established that any improvement in the economic or legal playing field that does not impose a cost of the state's resources is not within the scope of Art. 87(1).[289]

Once the conditions of Art. 87(1) are satisfied, the Commission may initiate a proceeding against the relevant MS to force her to remove the state aid and to return the funds already provided under the illegal measure.[290]

One immediate outcome of the application of Art. 87(1) is its direct effect and its possible application in situations of harmful tax competition. While both Art. 87(1) and the "Code of Conduct" may apply to similar situations (although the application of Art. 87(1) is much wider and covers many situations not covered by the "Code of Conduct" while at the same time not applying to all situations covered by the "Code of Conduct"), the application of the latter does not have the binding effect of the former. Unlike the recommendation form of the

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287 See generally, Edge & Airs (2003).
288 See generally, Schon (1999).
289 Schon (1999) at 922.
290 There are only limited exceptions to situation whereby, despite the existence of state aid, the MS may not return the money from the taxpayer/s who benefited from the illegal measure.

"Code of Conduct", MS that violates the prohibition in Art. 87(1) must remove the distorting legislation.[291]

In 1998, the Commission has announced its intention to apply stricter policy with respect to state aids provided in the form of selective direct tax subsidies by MS. Nonetheless, the enforcement of the State Aids provisions has been quite limited. This is probably the outcome the combination of the limited resources available to the Commission (which is in charge on bringing a claim to the ECJ) and the limited nature of the possible reward/damages that can be obtained as a result of a successful claim.[292]

An interesting point about the prohibition in Art. 87(1) is its interaction with ITA. One should pay attention to the increasing importance of ITA in the light of the restrictions imposed by Art. 87(1). Art. 87(1) only applies with respect to measures that are selective in their nature or apply with respect to certain type of undertaking or products. Art. 87(1) does not apply where the aid is regarded a being part of the general nature of the tax system and is not designed with respect to a specific type of transaction or with respect to specific type of products i.e. it has to be "selective".[293]

"While Member States are forbidden from granting direct or indirect funding to specific enterprises or groups of enterprises, it is part of fiscal federalism that each Member State offers broadly designed economic incentives which are – in principle – available to all agents within the economy and do not distort the Common market in specific areas."[294]

Thus, for example, the provision should not apply with respect to depreciation deductions even where the tax deductions are more accelerated than the economic depreciation provided the benefit is open to all economic agents and even if it causes private undertakings to increase investments.[295]

[291] In cases where the court finds the Commission complaint against a MS to be justified, the MS may be required, in addition to removing the incentive, also to recover the amount of state aid granted to its taxpayers.
[292] Recently, however, three decisions were made by the Commission: IP/04/404 (holding that the planned corporate tax in Gibraltar is not in line with EU State aid rules), IP/04/406 (approving the modified German environmental tax), and IP/04/405 (holding that an Italian scheme in favor of undertakings buying undertakings in liquidation infringes EU State aid law).
[293] For a discussion of the difference between the two types of aids – see generally Schon (1999) above. A good illustration of the difference is the tax measures adopted in Ireland. In the past, Ireland offered low tax rates with respect to companies with certain qualifying manufacturing or trade activities. This special rate was lower than the general rate applicable in Ireland at that time and was regarded as an illegal state aid. In contrast, recently Ireland introduced a new low corporate tax rate of 12.5%. Unlike the previous scheme, this low rate applies with respect to all Irish companies and is not designed with respect to a certain industry or sector. As such, it is not regarded as a selective measure and is regarded as part of the general scheme of the tax system, thus not subject to the application of Art. 87(1).
[294] Schon (1999) at 930.
[295] Schon (1999) at 927-928.

ITA is generally the outcome of an interaction between one tax system and other tax systems and need not involve a special or selective regime for specific type of activities. As such, it would usually tend to fall within the scope of the general nature of the tax system, not be covered by the state aids provisions.

At the same time, ITA may give rise to similar consequences as those that result from the use of selective measures that are caught within the scope of Art. 87(1), similar to a country reducing its overall corporate tax rate. I shall return to this point later below.

United States

> *"The concern facing this Subcommittee today is that our tax code has not kept pace with the changes in our real economy. International tax policy remains rooted in tax principles developed in the 1950s and 1960s. That was a time when America's foreign direct investment was preeminent abroad and competition from imports to the United States was scant. Today, we have a truly global economy. ... At one time, the strength of America's economy was thought to be tied to its abundant natural resources. Today, America's strength is its ability to innovate:...."* [296]

A General Overview of the International tax system

The US Federal tax system has been said to be based on three underlying distinctions.

The first distinction is between the taxation of domestic persons and foreign persons. The second distinction is between the treatment of active income and the treatment of passive income. The third distinction is between the treatment of ordinary income and the treatment of capital gains.

According to the first distinction, taxpayers who are considered as domestic persons are taxed with respect to their worldwide income regardless of its source. All other persons, those regarded as foreign persons, are taxed only with respect to their US source income.

When domestic persons invest abroad then the income should be currently taxed in the US. However, if this investment is made through the form of a foreign corporation, then the general rule is that the tax system will respect the corporate form and unless the foreign corporation has any income from a US source it will not be subject to tax in the US. This general rule, however, has many exceptions that would result in the disregard of foreign entities' corporate form and current taxation of the relevant share of their profits (or part thereof) in the hands of their US domestic shareholders. Thus, the US controlled foreign corporation (CFC) legislation treats certain profits accumulated in foreign companies

[296] Angus (2002), testifying before the Subcommittee on Select Revenue Measures on International Tax Policy and Competitiveness, the House Committee on Ways and Means.

controlled by US shareholders,[297] as if these profits are actually distributed to the US shareholders in absence of actual distribution.[298]

According to the second distinction, active income and passive income are treated differently for tax purposes. As a result of this distinction, several inconsistencies in treatment take place.

A domestic taxpayer, for example, is more likely to obtain deferral with respect to investment abroad where such investment gives rise to active income as opposed to passive income. Most (but not all) of the categories included in the CFC legislation target foreign passive income. The rationale is understood as targeting passive and highly mobile income. In addition, the PFIC and the FPHC legislations are aimed only at US held (not necessarily controlled) foreign corporations with mostly passive income. In all these situations, the incidence of passive income will, most likely, result in current taxation of the foreign income, regardless of distribution, while disregarding the foreign corporation's corporate form.

Similar distinctions exist in the application of the foreign tax credit rules and with respect to the treatment of foreign taxpayers operating in the US. With respect to the latter, different tests apply with respect to the determination of tax liability and its extent depending on whether the income is active or passive.[299]

Lastly, the third distinction is between the treatment of income and the treatment of capital both in timing of the income and in the tax rate that applies.[300] I return to this important distinction in the context of HFIs below.[301]

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[297] The term "US Shareholder" is a term of art defined to include a US resident holding 10% or more of the foreign company's voting power or equity (IRC §951(b)).
[298] IRC §951-957.
[299] In the former case (active income), the income is only subject to tax if the foreign person is engaged in trade or business in the US and to the extent such income is effectively connected with the conduct of such trade or business (where a double taxation income applies, the requirement is usually replaced by the threshold of income that is attributable to a permanent establishment of the foreign person in the US). If subject to US taxation, the income is taxed on a net basis at the applicable US tax rate. In the latter case (passive income), certain types of passive income, or FDAPI (Fixed, determinable, annual and periodic income) as defined by the US Internal Revenue Code are subject to US taxation. The tax is imposed by way of a 30% withholding tax on the gross amount. In most cases, a tax treaty between the US and the country of residence of the foreign person will significantly reduce this withholding rate.
[300] Accrual or mark-to-market (income) as opposed to realization (capital) and subject to the new partial exemption in the case of qualified dividends, 39.6% (individuals) or 35% (corporations) as opposed to rates of 20% or less in the case of long term capital gains.
[301] For example, pp. 146-147 below.

In addition, according to Avi-Yonah, the US system is also based on two principles, the single tax principle and the benefits principle, [302] that are discussed below. According to the former income has to be subject to a single level of tax, no less no more. According to the latter principle, the tax rate applicable is allocated in a way in which the country of source taxes primarily passive income while the country of residence taxes primarily active income.[303]

General Tax Policy

The Origin

Income tax in the US has its origin from the 1913 Income Tax Act which for the first time imposed income tax on a Federal level.[304] From its origin the income tax was based on the first distinction mentioned above, the distinction between domestic persons and foreign persons, taxing the former on a worldwide basis and the latter only on a limited source basis.

The origin of the residence based taxation of corporations can be found in the work of TS Adams who supported the imposition of tax on a worldwide basis so that the country of residence would tax the income in case the country of source fails to do so.[305]

Graetz argues that TS Adams, who was one of the most influential figures in the US tax world of the first quarter of the 20th century, had several policies in mind while advising and supporting tax reform. These were, fairness (or some sense of justice among taxpayers), elimination of double taxation but prevention of abuse, preservation of the tax base, easy administration of taxation, greater export of US goods and capital, elimination of tax avoidance devices, and above all, promotion of the principle of "enlightened self-interest" among countries to maintain good tax laws.[306]Adams disregarded economic policies and used other reasons, primarily, fairness, easy administration of taxes and the principle of "enlightened self-interest" at the center of his policymaking. Thus, supporting the enactment of the foreign tax credit in 1918, he did not use CEN but rather fairness, arguing that in the light of the very high rates it would not be fair to subject a taxpayer to double taxation (which would result under the foreign tax deduction system that existed then). On the other

[302] Avi-Yonah (1997).
[303] Avi-Yonah (2000).
[304] For the sake of completeness – it is necessary to mention that income tax was introduced for the first time following the US Civil War. See Brownlee (1996) at 26-27 (it was then later withdrawn and re-introduced in 1913).
[305] Avi-Yonah (2000) referring to the work of Graetz & O'Hear (1996-1997).
[306] For a general description and analysis of TS Adams' work – see Graetz & O'Hear (1996-1997).

hand, in 1921 when the foreign tax credit limitation was added, the reasons were prevention of tax abuse and preservation of the US tax base.[307]

During Adams times, the tax system respected the separation of the corporate form and did not impose current taxation on foreign investments by domestic taxpayers using foreign corporations. The application of this principle was restricted with the enactment of the foreign personal holding companies legislation in 1937 and later in 1962 with the enactment of the controlled foreign corporation legislation and then again in 1986 with the enactment of the passive foreign investment company legislation.

The Deferral Debate

In 2001, in a much-debated report[308] the US Department of Treasury mentioned the following policy considerations as those that were included in the original 1962 debate: the desire to promote equity and to promote economic efficiency, to prevent abuse by taxpayers but not harm competitiveness.

Until 1962 only a limited number of domestic taxpayers who invested in foreign countries through foreign corporations were subject to current US taxation. The rest were able to enjoy the deferral and to the extent this income was not repatriated back to the US, the deferral was permanent. Ending the deferral would have ensured that to a large extent tax does not play a role in determining whether to invest domestically or abroad. This is also the rationale behind CEN. This, however, is not completely correct. Nor is it what took place at the end.

There were two types of targeted transactions, those involving passive tax haven income and revenue shifting transactions. The rationale for targeting the first type was its nature, passive income that did raise any objections based on competitiveness. Again, we return to the distinction between active and passive income. Active income – deferral allowed – corporate entity and foreign person principles – respected whereas passive income – none of these principles is followed.

Subpart F, however, is more than just ending the deferral on passive income. The second type of transactions targeted by the legislation was transactions with related parties that despite their apparent active character involved revenue shifting from high tax jurisdictions (not necessarily the US) to low tax jurisdictions. In this way, the worldwide tax liability was

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307 Otherwise the foreign tax credit might eliminate US taxes completely in a way that would require the US to refund / finance part of the foreign tax paid on the investment.
308 US Treasury (2000).

reduced, although it was not necessarily the US tax liability. The rationale seems to focus here more on the prevention of abuse and maybe equity than on neutrality or economic efficiency. This, however, is not very clear.[309]

The legislation adopted (which to a large extent exists today) was a political compromise between the President's proposal on one hand and the Treasury proposal on the other. The President's proposal which supported a complete end of deferral (also with respect to active income) was justified as necessary in the light of "*changing economic conditions at home and abroad, the desire to achieve greater equity in taxation, and the strains which have developed in our balance of payments position in the last few year.*"[310] Among the reasons for the President's proposal was the need to achieve an efficient allocation of resources and an equitable treatment of US taxpayers, two aims that did not exist prior to 1962 as US taxpayers were encouraged to invest abroad (instead of domestically) and do so through the use of a foreign subsidiary (as opposed to a branch).[311]

The more limited Treasury proposal was based on the premise that the President's proposal was too wide and was likely to harm the competitiveness of US firms operating abroad. To preserve the competitiveness of US firms, the Treasury proposal would end deferral only with respect to what was referred to as "tax haven transactions", thus carving out non-passive income, dividends, interest, rents and royalties derived from active conduct of activities if were done with unrelated parties.[312]

At the end, it was a compromise that balanced between the desire to follow CEN on one hand and the need to preserve the competitiveness of US firms abroad on the other hand. This compromise resulted in several uncertainties, as I shall further discuss below.

The above-mentioned Treasury report on deferral did not end the debate. On the contrary. In the years that followed, much was written on the debate regarding the US international tax policies and more specifically on the appropriate scope of Subpart F. In their report, following the issuance of the Treasury Report, the New York State Bar Association criticized the Treasury for concentrating too much on attempts to justify the existing system

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309 An important distinction that exists throughout the CFC legislation as well as other areas of the US tax system is the distinction between active and passive income. In this context, while passive income is almost automatically "tainted" and prevented from enjoying the deferral, active income is so "tainted" only when it is being "shifted" from its logical business situs for tax reasons.
310 US Treasury (2000) at 111 citing the President's message.
311 US Treasury (2000) at 118.
312 US Treasury (2000) at 113-114.

while not examining the impact of the legislation on US multinationals' ability to compete and by failing to examine alternative options to tax foreign source income.[313]

This is in addition to the National Foreign Trade Commission's (NFTC) view that the current scope of Subpart F is too wide and should be restricted to cover only two fundamental cases where deferral is inappropriate. They base their view on arguments of equity, competitiveness and compatibility with international norms. According to the NFTC, when one company is subject to a heavier tax burden vis-à-vis its business competitors, it suffers from a competitive disadvantage. Competitiveness, according to the NFTC was recognized to be an important policy consideration back in 1961 when the US had dominance in the international markets and US MNEs represented 8 out of the world's largest MNEs. Therefore, today, when the markets are much more competitive and when the US is in a much less dominant position, the importance of competitiveness as a policy goal is even greater.[314]

In 1998, the Treasury issued *Notice 98-11*[315] and proposed regulations that were meant to apply Subpart F to transactions between foreign hybrid entities. Although both notice and regulations were withdrawn, they provided an opportunity to discuss the policies underlying Subpart F and especially with respect to what is exactly referred to by "active income" and where the line should be drawn with respect to the scope of Subpart F.[316]

According to Avi-Yonah, the problem with Subpart F, thirty-six years after its enactment, is that the dichotomy upon which it is based no longer exists. In 1962, there were two main groups, active business income and passive tax haven income. Deferral was allowed to the former but denied from the latter.[317] In 1998, a new type of tax havens exists, manufacturing tax havens, where taxpayers are earning active business income while enjoying tax haven treatment; a treatment that should have been caught within the scope of Subpart F. The assumption that active business income cannot be conducted in low-tax jurisdiction does not exist anymore. Otherwise it would be very difficult to explain the dichotomy that was drawn between tax haven activity and legitimate manufacturing operations. Although it is appropriate for this type of activity to be included within the scope of Subpart F, in the light

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313 NYSBA CRITICIZES TREASURY'S SUBPART F STUDY, 2002 WTD 9-24.
314 NTFC (2001). Cf. Avi-Yonah's arguments below.
315 Notice 98-11, 1998-1 C.B. 433.
316 In addition, and more relevant to our purposes, it appears that as a result of the withdrawal of Notice 98-11 and the proposed regulations (Notice 98-35, 1998-27 IRB 1), Subpart F is probably inapplicable in situations which were meant to be covered in the notice and regulations, situations whereby a US taxpayer is using foreign hybrid entities to reduce his foreign tax liability by using hybrid entities that are engaged in foreign transactions between related parties which escape the application of Subpart F due to their hybrid nature (they are treated as foreign corporations for foreign tax law purposes and as transparent for US tax purposes).
317 Avi-Yonah (1998).

of the change in practice and of the OECD Harmful Tax Competition initiative (which according to Avi-Yonah supports his argument), Congress should amend the legislation to include such manufacturing tax haven income within its scope and deny deferral in these situations.[318] Until then, US-based corporations have the opportunity to earn tax-free income abroad through a combination of manufacturing tax havens that enjoys tax deferral and the ability to cross-credit foreign tax credits. This provides an advantage to US-based corporations with foreign operations vis-à-vis US-based corporations with domestic operations and Congress should amend this distortion.[319]

The Inversions Debate

This discussion continued in 2002, as a result of several successful inversion transactions in which US based multinationals converted into foreign held multinationals, without much change to their operations and as a result of the relatively high tax burden imposed on US based multinationals.[320]

One of the arguments raised in justification of the inversion transactions was that the US tax system imposes a very heavy tax burden on its multinationals thus putting them in a competitive disadvantage vis-à-vis foreign multinationals and in particular European based multinationals.[321]

In the words of the Treasury International Tax Counsel, *"[B]oth the increase in foreign acquisitions of U.S. multinationals and the recent corporate inversion activity are evidence that the potential competitive disadvantage created by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S economy."*[322]

This competitive disadvantage together with the relative ease in which it was possible for non-US resident corporations to operate in the US at the same level playing field (and

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[318] *Ibid.* cf. Hariton (1998), who argued that it is a political question rather than a technical analysis. This political question is whether the US should permit a foreign country to use tax holidays to attract business capital out of the US. To a large extent, the answer, according to Hariton, depends on whether it is a Republican or a Democratic Congress.
[319] Avi-Yonah (1998b).
[320] An inversion transaction is generally a transaction whereby a US-based multinational converts into being a foreign-based multinational, with its parent company residing outside the US, mostly in a favorable tax jurisdiction. There were many ways, taxable and non-taxable, in which an inversion transaction could have taken place. The trigger to the trend in around year 2000 was the drop in share prices (together with losses) of many of the companies that wished to carry on such transactions, a drop that allowed them to carry out these transactions as taxable transactions that were not subject to tax due to the loss on the shares for most of the shareholders and the loss at the corporate level that offset the resulting gains. See generally, NYSBA (2002).
[321] NYSBA (2002) at 9-10. The report discusses situations in which these disadvantages are reflected – for example in the ability to offer competitive bids in acquisitions of foreign businesses and in entering into foreign investments. (at 11-12).
[322] Angus (2002).

sometimes even on an higher playing field than US competitors) led several US multinationals to conduct an inversion and re-incorporate as a multinational with a foreign parent company at a relatively low present cost and with a high potential for long term benefit, a benefit that would result from the exemption from US tax of all of the non-US business. Following the inversion transaction, which was tax-driven, the multinational was not subject to the rules of Subpart F with respect to its worldwide income and in addition was able to reduce its US tax with respect to its US income by financing its US operations with leverage that would pay deductible interest from the US company to related companies outside the US.[323]

As a result, it was proposed to adopt a two-parts solution. On one hand, to make it harder for US based multinational to invert and re-establish themselves as foreign-based multinational and one the other hand, make it more difficult for foreign-based companies to operate in the US. In other words, to raise their level playing field in the US market vis-à-vis US based companies.

Avi-Yonah disagrees with the often use of competitiveness in the policy debate, especially in the context of the above-mentioned inversion transactions. Such link between the desire of corporations to invert and competitiveness is misleading. After questioning the link between the improvement in the competitiveness of US-based multinationals and the welfare of the US economy, Avi-Yonah continues to question the link between the inversion transactions and the competitive disadvantage in which US-based corporations are located. For example, if the US was to adopt a territorial based tax system, would this change stop US-based multinationals from inverting? The answer according to Avi-Yonah is no. The basis for this answer lays in the rationale behind the inversion transactions. These multinationals are not only interested in reducing the tax liability with respect to their foreign source income but would also like to reduce the tax liability with respect to their US source income. This would not be achieved by a change to a territorial tax system. Competitiveness is not really the issue.[324]

Rosenbloom gives a good illustration of the issue,

"No reasonable person would oppose the goal of maintaining competitiveness of US-owned foreign corporations. The hard question is, what that implies for the rules of tax policy. If it

[323] In addition to favorable transfer pricing planning that would minimize the extent of income allocable to the US company. See generally, Avi-Yonah (2002).
[324] *Ibid.*

implies rules that guarantee the ability of US-owned foreign companies to stand toe-to-toe with foreign firms engaged in similar active business, that is one thing. If it implies adopting in US law the most taxpayer favorable rules from every other industrialized country, that is something entirely different."[325]

Foreign Tax Credit[326]

Another area of the tax law where the policy can be explored is the rules governing foreign tax credit. As it is described above,[327] the main rationale for having a credit mechanism as opposed to its predecessor, the deduction mechanism, seems to be the desire to achieve equity for the taxpayers and to eliminate the double taxation whose burden was perceived as cumbersome. CEN was not a concern in 1918 when the original legislation was adopted, although many commentators today might try to link it to the discussion. In 1918 when TS Adams first added the foreign tax credit to the US tax code, it was added without any limitation based on the following justification:

"... if one taxpayer is being taxed twice while the majority of men similarly situated are being taxed only once, by the same tax, something is wrong or inequitable is being done which, other things being equal, the legislator should correct if he can."[328]

It was only in 1921 when the first credit limitation was added to the tax code. The rationale behind the legislation was to prevent taxpayers from reducing their US tax liability with the use of foreign tax credit against the higher foreign tax rates that existed at that time. Since then, many changes took place but this limitation remained, together with some additional limitations that were added during the years.[329]

In *Notice 98-5*,[330] the Treasury sought to prevent some of what it regarded as abusive use of the foreign tax credit rules by focusing on situations where taxpayers entered into transactions that were not economically justifiable but for the foreign tax credit benefits they entail. I return to discuss the notice in more detail below in the context of HFIs.[331]

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[325] Rosenbloom testifies on need for new international tax plan, 2003 TNT 136-31 at ¶5.
[326] For a general overview and analysis of the US foreign tax credit rules, see Dolan.
[327] See p. 98 above.
[328] TS Adams, International and Interstate Aspect of Double Taxation, Nat'l Tax Ass'n Proc. 193, 198 as quoted by NFTC at 10.
[329] In addition to the general limitation, the US foreign tax credit regime uses the "baskets" limitations to prevent taxpayers from offsetting credits from one type of income (passive) against income from another type of income (active) and vice-versa.
[330] 1998-1 C.B 334; 1998 IRB LEXIS 15; 1998-3 IRB 49.
[331] See pp. 162-163 below,

Many taxpayers, however, regard the foreign tax credit regime as a complex regime that results in high compliance costs, distortions and double taxation. According to the NFTC, the foreign tax credit regime that was originally enacted with the underlying principle of creating equity among taxpayers, leads today to the opposite result by creating artificial excess credit situations that prevent the taxpayer from obtaining his fair share of foreign tax relief.[332]

In addition to the direct foreign tax credit, the US tax system allows indirect foreign tax credit in the case of domestic corporations holding 10% or more in the shares of foreign corporations with respect to the dividend income distributed from these foreign corporations.[333]

"The rationale for the indirect credit is the same as the rationale for the foreign tax credit generally, i.e., to avoid double taxation of income. In addition, the indirect credit rules have been described as intended to eliminate the disparity that would otherwise exist between foreign branches and foreign subsidiaries of U.S. corporations."[334]

The indirect foreign tax credit provisions are aimed at answering two concerns, the proper taxation of international investment and multiple corporate taxation

"The justification articulated most frequently by tax policy experts for the current U.S. regime for taxing foreign income of U.S. persons is "capital export neutrality": Income taxes should not affect the location of business investment. From the capital export neutrality perspective, dividends from foreign corporations should be treated similarly to dividends from U.S. corporations. To achieve this harmonization, § 902 must conform to the narrower tax exclusion for domestic intercorporate dividends. Moreover, competing U.S. international tax policies provide little support for the current broad credit. Foreign withholding taxes and tax treaties complicate the analysis, but have little impact on the conclusions."[335]

I return to the provisions of the foreign tax credit below.[336]

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[332] According to the NFTC, the premise on which the limitation preventing the cross-crediting is based is that the reduction of US tax rate would leave many US-based companies with significant excess foreign tax credits. In practice, the opposite took place leading to an inefficient foreign tax credit regime.
[333] Unlike the UK tax system, an indirect tax credit is allowed under the US tax system only until the 6th tier subsidiary.
[334] See generally, Carr & Moetell.
[335] Mundstock (1992-1993).
[336] See pp. 160-163 below.

Where do we stand today?

Concluding their above-mentioned report on tax deferral, the Treasury noted that during the years and in the light of several developments, Subpart F, in its current version, became somewhat outdated.[337] Although the Treasury made no recommendations as to the approach to be adopted to make the legislation more capable of dealing with the new challenges, it stressed that such reform must be made in the light of the fundamental goals of international tax which are, to further the goal of equity, to promote the goal of economic efficiency (by "*reducing the disparity between income from US and foreign investments*"), to promote simplicity and administrability and to promote the goal of consistency with international norms.[338]

According to the Treasury, following a careful examination of economic literature, they are of the opinion that CEN is probably the best policy when the goal is to maximize economic welfare and thus preventing significant tax disparity should remain an important policy.[339] These conclusions were not shared by all.[340]

In a recent testimony before the US Senate Finance Committee, Pamela Olson, a senior Treasury official recognized the need for a new international tax plan. According to her testimony, the major changes that were made in 1962 did not progress with the economy and are no longer adequate to deal with the current state of the economy which became much more international. Since then there has been significant changes. Cross-border trade in goods increased from just over 6% of GDP in 1960 to over 20% today while trade in goods and services represent over 25% today.[341] In addition, there has been a significant increase in cross-border investments to the US (from just over 1% in 1960 to more than 11% in 2001). Moreover, US multinationals represent more than ¼ of the US output, approximately 15% of US employment and their output represents between 50-75% of the US exports annually.[342]

As a result there is a great concern that the US tax code has not kept up to date with the changing economy. Olson focuses on three main points in her testimony. First, the necessary changes to be made to the US Subpart F legislation which is far too wide than it should be and covers also active income "*arising from business operations structured and located in a*

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[337] The three major challenges mentioned by the Treasury are the entity classification rules ("check the box"), the growth of services in the global economy, and electronic commerce.
[338] US Treasury (2000) at 98-99.
[339] US Treasury (2000) at 99.
[340] NFTC (2001).
[341] The increase in the amount of service and its impact on cross-border trade is one of the most important points stress by most commentators on the subject.
[342] Olson testifies on need for new international tax plan 2003 TNT 142-32, at paragraphs 111-117.

particular country from business reasons wholly unrelated to tax considerations".[343] [344] Second, changes necessary with respect to the existing foreign tax credit regime which is detailed and complex and has the effect of subjecting certain US firms to double taxation on their foreign earned income.[345] The overall effect of these two points has the effect of putting US based firms at a disadvantage vis-à-vis foreign competitors who either come from countries that use the territorial basis for taxation or have more limited CFC legislation or does have so many limitations with respect to their foreign tax credit relief.[346] Third, the need to reduce the complexity of existing rules which are extremely complex and especially those rules dealing with international taxation.[347]

According to Olson, the impact that revenue-raising considerations have on tax policy raises some concerns with respect to sound tax policy decisions,

"Now, there may be other things that we could do that would ameliorate that effect, but one of the concerns that I have had over the last couple of years in looking at our formulation of tax policy, is that we seem to make our decisions purely on the basis of revenues as opposed to sound tax policy. And I think that we let the revenues derive our tax policy decisions, we are probably making some mistakes in terms of the effect on the economy."[348]

In a following testimony Hines summarizes his study on the competitiveness of US firms and comes up with two conclusions. First, that the ownership and activities of multinational corporations are highly sensitive to taxation, much more than was thought previously. Second, that competitiveness of the world economy has the power to change everything about the structure and characteristics of a national tax system that seeks to promote economic efficiency. These two conclusions have a dramatic effect on the US tax system that is based on principles and ideas that existed in the 1960s and before, when the world economy was much different.

The main point in his testimony is the grave effect the current tax system has on the ability of US based firms to compete in the world economy. First, Hines argues that according to their recent research, the US tax system efforts to tax foreign source income at the same way

[343] *Ibid* at para. 125.
[344] Olson Testifies at Finance Committee's Second Hearing on International Competitiveness, 2003 WTD 137-16 ("*In other words, in seeking to capture as much passive international income as possible, subpart F captures a large share of active income as well, putting the companies that earn this active income at a distinct competitive disadvantage.*").
[345] 2003 TNT 142-32 at para. 126-128.
[346] *Ibid* at para. 204. This point is further explored in Assistant Secretary Olson's written testimony – 2003 WTD 137-16.
[347] *Ibid* at para. 131-133.
[348] *Ibid* at para. 391.

it taxes domestic source income is likely to reduce the productivity of the world economy and the well-being of Americans. Although some might argue that the difference between the US tax system and other countries' tax systems are not that grave, Hines believes that even these differences are sufficient to influence the competitive of US based firms in certain markets.

The existing US tax policy is based on the premise that the more US firms invest abroad, the less they can invest domestically. As a result, based on the (outdated) assumption that US investments are not affecting foreign investments, the more US firms invest abroad, the lower the level of US investments will be.[349] Thus, national welfare is maximized by taxing foreign source income of US firms and worldwide welfare is maximized by allowing foreign tax credit. According to Hines, this view fails to recognize the consequences of the global competitive market where US direct investment abroad trigger more foreign investments in the US.[350] Thus, the approach that investment of US firms abroad reduces the level of investment in the US is no longer valid.

Based on the inadequacy of the basic premise, Hines overall conclusion is that the current policy objective of the US tax system lead to the opposite results i.e. that it is *"detrimental to the functioning of world economy and contrary to US interests."*[351]

Rosenbloom recognizes the problematic state of the current international tax rules and is of the view that there is a need for a genuine reform and not just piecemeal changes.
The two major problem areas apart from complexity are the CFC regime and the foreign tax credit rules.[352]

According to Rosenbloom, one of the basic flaws in the existing CFC rules and their application is the assumption that all foreign tax jurisdictions stand at the same footing.[353] Current CFC regime should change to impose more restrictions on income not attributable to active business income and income that is earned in tax haven jurisdictions. Such income, according to Rosenbloom, does not raise a competitiveness concern. At the same time, he

[349] *Ibid* at para. 428-431.
[350] *Ibid.*
[351] *Ibid.*
[352] For a thorough discussion of Rosenbloom's view regarding CFC and the question of deferral, see Rosenbloom (2001).
[353] 2003 TNT 142-32 at para. 514.

proposes to introduce an exemption with respect to active business income, an exemption that would serve the purpose of maintaining the competitiveness of US businesses.[354]

The more significant problem is with respect to the US foreign tax credit rules, which became amazingly complex.[355]

As far as the competitiveness argument, despite Avi-Yonah's important criticism, it appears that Congress was interested over the years to promote the competitiveness ability by advancing certain measures that improved the position of US-based companies vis-à-vis foreign competition.[356] These measures suffered a significant setback recently when the WTO found both the FSC regime and its successor the ETI regime illegal subsidies.[357] As a result, the US is forced to repeal the ETI regime. No replacement has been announced. Even if there is a new measure to replace the illegal ETI regime, one should wonder, what benefit, if any, does that have of the welfare of US residents.

The Foreign Policy Element

As it is already mentioned above,[358] in addition to political considerations, international relations play an important role in US international tax policy. Although most of the academic discussion tends to focus on the elements discussed above,[359] a brief look at the US tax code and regulations would establish that the US is using its international tax system also to further certain (although limited) political goals. For example, as part of the US CFC legislation, an income would be regarded as Subpart F income if it originates from a country that is on the list of boycotted countries.[360] There is no other policy goal that justifies a different treatment for this type of income and for that purpose it does not matter if the income is passive or active income. Similar provisions exist in the foreign tax credit rules which do not entitle a taxpayer to receive foreign tax credit with respect to foreign tax paid to a boycotted country.[361]

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354 In a reply to a question by the committee, Rosenbloom commented, "*I realize that this is a political process. But, if one could move to a prefect system, an ideal system for the United States, in my view we would not tax active foreign business income.*" (*Ibid* at para. 595).
355 *Ibid* at para. 596.
356 Among these measures are the former FSC/ETI regimes, the rules dealing with the Subpart F / PFIC overlap, the repeal of §956A, etc.
357 See also Angus (2002).
358 Please refer to the discussion with respect to foreign policy above (pp. 65-66).
359 See pp. 23-64 above.
360 IRC §952(a)(3)(B).
361 IRC §901(j).

At the same time, it is important to recognize that unlike other countries, the US has always maintained its unwillingness to grant subsidies to foreign countries through the tax system in the form of "tax sparing" clauses, whether it is in domestic law or as part of a DTC.

Inbound Investments

When examining the US treatment of inbound transactions i.e. transactions by foreign persons investing in the US, again the active passive distinction reappears. As discussed above,[362] there is a basic distinction between the tax regime that applies with respect to active income and the tax regime that applies with respect to passive income.

At same time, the US employs separate approaches with respect to withholding taxes. On one hand, it imposes a very high withholding tax rate with respect to passive income. This rate is usually reduced (significantly) by the application of double tax conventions (and it has been argued that the only reason for retaining such high rate is to serve as a bargaining tool in the negotiation of new double tax conventions). On the other hand, two important categories of passive income are outside the scope of this high rate. The first, exemption of capital gains with respect to personal property in the hands of foreign persons.[363] The second, portfolio interest exemption, with[364] the rationale of attracting foreign debt holders and promoting the US financial markets to foreign investors.[365] This latter exemption should be contrasted with the treatment of dividends, which unless a double tax convention provides otherwise, are subject to a 30% withholding tax rate.

Another distinction in the treatment of foreign inbound investments can be made between direct and portfolio investments. In general, it is possible to argue that portfolio investment is treated more favorably than direct investment.[366] The difference in approach is seen in the level of scrutiny that direct investment transactions receive vis-à-vis portfolio investment transactions and can be probably explained as follows: whereas the US is keen in attracting foreign portfolio investments into the US capital market, it is not willing to allow foreign residents investing directly in the US to gain a competitive advantage vis-à-vis domestic multinationals. Attracting foreign investments to the US capital markets improves the liquidity of the markets and allows US companies to reduce the costs of finance, thus improving their competitiveness in the global markets. On the other hand, allowing foreign taxpayers to structure their operations in the US market though the use of advanced financing techniques which are to a large extent tax driven, would create an advantage for these companies vis-à-vis US companies and would make it much more attractive to operate

[362] See p. 97 above.
[363] This exception generally does not apply with respect to capital gains from the disposition of real estate.
[364] With respect to this latter exemption, several commentators (including Professor Avi-Yonah) use it as an example for the "race to the bottom" argument (Avi-Yonah (1998c).
[365] For criticism of this exemption, Avi-Yonah (1998c).
[366] See for example, the portfolio interest exemption and the exception granted to non-resident investors operating in the UK through a trader.

in the US as a foreign company.[367] As a result, whether it is for the competitiveness reason mentioned above, for the reason of protection of the tax base, prevention of base erosion or just to prevent "abusive" application of US domestic laws and double tax conventions, a number of anti-planning provisions apply to this type of inbound transactions. An example for such mechanism is the earning stripping rules.

This tax planning ability was enhanced in 1996 when the US adopted the "check the box" regulations allowing taxpayers to elect the tax classification of their entity (including for that purpose, foreign entities). Although the rationale behind the legislation was to simplify the legislation that existed at the time by allowing taxpayers to make the choice instead of applying a factors test that was to some extent elective, the ability of taxpayers to elect the tax classification of their entities resulted in tax advantageous schemes that allowed foreign taxpayers to finance their operations in the US on better terms than their US based competitors. This led the Treasury and the IRS to introduce the Domestic Hybrid Entities regulations. This legislation can be seen as a policy approach by the US in which it has emphasized its insistence to ensure that its legitimate expectations are being met. When it was introduced, it was added to the already existing regulations dealing with dual resident companies[368] and with conduit entities.[369]

According to Kingson, when the US is waiving part or all of its taxing right with respect to an item of income it does so based on the expectation that the item of income shall be taxed by the other country.[370] For many years, the US has insisted on a high withholding tax rate with respect to certain types of income, mainly to create a good starting position for its negotiators in the course of new tax treaty negotiation.[371] In order to maintain the US expectations, it should ensure that it does not waive its taxing rights for free.

According to the Treasury, *"[T]he agreement by the source country to cede part or all of its taxation rights to the treaty partner is predicated on a mutual understanding that the treaty partner is asserting tax jurisdiction over the income. ... This principle is central to the interpretation of treaty provisions in determining the extent to which payments received by a hybrid entity are eligible for treaty benefits."*[372]

[367] See also the discussion regarding the Inversions Report above.
[368] IRC §1503(d).
[369] US Treasury Reg§1.881-3 regulated under the authority of §7701(l) and §1503(d) respectively.
[370] Cf. the exemption allowed for portfolio interest that is discussed above (p. 111).
[371] Kingson (1981).
[372] Preamble to regulations under §894 (T.D. 8722) quoted by Ring (2004).

This strict approach should be contrasted, however, with a more lenient approach with respect to outbound transactions. As a general rule, the structure of the US tax system makes the opportunities for non-taxation more limited. Although the US imposes relatively strict limitations with respect to the appropriate application of the foreign tax credit regime, this approach has its limitations, usually with a "competitiveness" tag on it. A good example for such limitation is the withdrawal of the above-mentioned Notice 98-11.[373]

I examine these provisions and others in more detail below.[374]

[373] See p. 101 above.
[374] See pp. 159-163 below.

Chapter 6 - Hybrid Financial Instruments

An area that poses many challenges to tax policy makers, governments and taxpayers is the taxation of financial instruments. The existence of an international network of capital markets in which transactions can be carried out, its global nature and the relative ease with which funds can be transferred freely from one country to another and with which cross-border transactions are carried out pose a real challenge to existing tax systems that are already challenged by domestic national financial instruments.

Even without looking at the cross-border level, at the domestic level, financial instruments pose a significant challenge to the tax systems. Tax systems generally distinguish between different types of payments in a way that may lead to discontinuities.[375] The relative ease in which one product can be re-designed and re-packaged as another product, which mimics the former product's economic characteristics but is taxed differently due to its new structure allows taxpayers to achieve a favorable tax treatment at little or no cost.[376]

With this progress and creativity, a corporation can create its own unique instrument that on one hand is capable to achieve the desired legal classification and on the other hand the desired economic and tax result.[377]

As a result, a tension exists between the legal principles that to a large extent regulate the tax treatment of the instrument and the economic principles that govern the design and structure of the instruments for financial purposes.[378] The evolution of this tension has taken place both at the domestic level of each tax jurisdiction and at the international level in the interaction between the different jurisdictions.

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[375] For example, the different treatment of capital gains and ordinary income and the different treatment of dividend and interest income. For the latter, please refer to our discussion below.

[376] The call-put parity is a good illustration to the difficulties faced by tax designers in structuring a tax system that is able to deal with the taxation of financial instruments. The put-call parity is a basic principle of corporate finance that sets up the foundation to many of the more complex instruments available today. According to the parity, an ownership of a share is economically equal to the ownership of a zero coupon bond together with a long position on a put option to sell the share and a short on a call option with respect to the share, both options being identical with respect to their terms and maturity. See generally, Knoll, (2002-2003).

For example, instead of owning a share, the investor is able to achieve the same economic result if he buys the bond and holds the two positions in the options. Nevertheless, from a legal perspective, the investor does not own the share even if economically he is in almost (or exactly the same) position as if he owned the share. In that way, for example, a fund, which is not allowed to invest in shares, can still achieve the economic outcome of investment in shares even without investing in shares.

[377] Pratt (2000) at 1075-1076 (explaining the rationale behind the innovation).

[378] See generally, Hariton (1994) and Polito (1992). For example, certain voting rights usually associated with shares and do not exist in the absence of shares even if economically, the return is similar to the holding of shares.

The following case study focuses on the taxation of hybrid financial instruments (HFIs). For that purpose, I first introduce the distinction between debt and equity which is the basis to the taxation of HFIs and move to discuss the way different approaches taken in the US and in the UK to the taxation of HFIs.

The Traditional Distinction Between Taxation of Debt and Equity & Its Rationale[379]

> "So long as Congress insists on providing for radically different tax treatments of debt and equity capital, lawyers must do their best to make the distinction meaningful."[380]

Traditionally, tax systems (the UK and the US being no exception) drew a distinction between the treatment of debt and the treatment of equity for tax purposes.

Debt is regarded as a loan by the lender to the borrower of funds to be used over time. At the end of the time period these funds are to be returned to the lender together with interest, which represented the compensation for the use of the funds during that period. As a result, if the borrower uses the funds in the course of business, the payment of interest is deductible as part of the costs of business. The return of the funds (the principal) is not treated as a tax event because the borrower is merely returning the asset he previously borrowed. Regardless of the changes in the borrower's business performance, the same amount[381] is due on the agreed date. As for the lender, he is not taxed on the return of the funds (again, it was merely the return of the asset that was previously borrowed) but only on the interest received. If he lends funds in the course of his business then this interest is treated as income of the business. With respect to this interest payment, special rules govern its taxation.

On the other hand, if the investment is seen as an equity investment, a different tax treatment applies. Any payments made by the company to the investor are treated as a distribution of profits, which is not allowed as a deduction for the distributing company. At the investor level, the distribution is either taxed as ordinary income in the US and as schedule F income in the UK or, in the case of companies, partly or fully exempt from taxation.[382] Unlike interest payments that, in most situations, are taxed even if not paid, distributions become taxable only when paid regardless of the identity of the parties or their relations. The rationale underlying the deferral is that the income does not belong to the recipient until the time of distribution.[383]

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[379] For a general discussion of this topic, see Edgar (2000); Wood (1999); and in a more US context, Polito (1992); Hariton (1994) and Pratt, (2000).
[380] Hariton (1994) at 502.
[381] Plus a certain amount of interest that effectively compensates the lender for the time value of money.
[382] Recent changes in US tax laws allow for partial exemption of certain dividends received by individuals from certain qualified companies (see above in the general discussion on the US). This new measure is limited in time and is due to sunset in 2008.
[383]The traditional company law view is that the dividend exists only from the time it is declared by the appropriate body in the company. Thus, in some countries, from a corporate law perspective, the right for the dividend amount is only created following a decision by the board of directors to distribute dividend in the

When the investor wishes to dispose of his investment, any gains are taxed as capital gains, sometimes subject to a preferential tax rate and enjoying certain adjustments of the purchase price (usually indexation adjustments). However, no tax is imposed as long as there is no realization of the gain on the disposition of the investment, and even then, there are some provisions that would defer the tax even further in the case of certain exchanges.[384] Thus, there is no current taxation of any changes in the value of the investment and any change that may take place is taxed only on disposition.[385]

Thus, on one hand, equity investment enjoys a tax deferral until the dividend is declared whereas interest income (on a debt instrument) may be taxed on either an accrual or mark-to-market basis even if no actual payment is made.[386] On the other hand, equity investment may lead in certain jurisdictions to double taxation of the same income once at the hands of the corporation and once at the hand of the shareholders whereas income on debt instruments is usually subject to only one level of tax.

According to the General Reporter to the 2000 IFA Congress, potential considerations that may influence a decision whether to structure the instrument as debt or as equity, include also, in addition to the considerations mentioned above, among others: the potential exemption from withholding tax of certain interest payments on debt instruments that are made to non resident investors and timing differences that may result from different methods that are used by countries in recognizing income and allowing deductions. In the latter, some countries would tend to recognize interest payments based on an accrual or even mark to market basis regardless of whether actual payment is really made (not to mention situations where original issue discount rules exist, in which case the discount amount is also recognized as income, sometimes even during the life of the debt instrument) whereas dividends paid on equity investments are usually recognized only when the income is actually received.[387]

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relevant year (this may change from jurisdiction to jurisdiction and from one type of share to another (i.e. common shares v. cumulative preferred shares). In debt instruments, however, the right to receive the interest payments is embodied in the debt instruments documents issued at the time the debt is created.

[384] For example, IRC §351 and §368(a) in the US and s. 132 TCGA 1992.

[385] Subject to situations where the holder is treated as a trader and current taxation may apply (for example, in the form of mark-to-market).

[386] In certain situations, there is no deferral of tax on income from equity instruments until the actual receipt of the income. For example, in certain countries, CFC regimes regard certain undistributed earnings of controlled foreign companies as if distributed to the shareholders. As a result, these shareholders may be subject to tax even though no actual distribution is made. See, for example §951-957 of the US Internal Revenue Code.

[387] Duncan (2000) at 23.

The rationale for the difference is argued to be the different nature of debt and equity. In the case of debt financing, the lender is not participating in any way in the business adventure of the borrower. He is merely supplying funds for a limited period and thus being compensated for his own inability to use these funds during the period of the loan (interest). The lender is not taking part of the business adventure and does not expect to receive any gains apart from the compensation for the use of his asset, the funds. At the same time the lender is not exposed to the risks of loss and regardless any losses the borrower's business enterprise might incur, the lender expects to receive back the full principal plus interest.

In the case of an equity investment, the investor is taking part in the adventures of the business of the company in which the investment is made. Thus, he is subject to both risk of loss and potential for gain that might result from such adventures. For that reason, there is no clear certainty with respect to the amount of return on investment until final disposition of the investment. Similarly, in equity's pure form, the investors have no certainty with respect to possible distribution of profits until the actual distribution is made. This basic difference in the nature of the investment on one hand and the nature of dividend payments v. interest payments on the other, forms the basic difference in the treatment of debt and equity.[388]

This traditional distinction between debt and equity started to lose much of its original rationale as it became apparent that the reasons and justifications that led to the introduction of the original distinction in the first place are questionable today.

Several changes in the nature of business and commercial practice have led to a situation whereby, especially with large publicly traded companies, little difference exists between equity and debt. The former limited risk debt became much more risky, equity investments became not much riskier than debt investments and equity investors became less actively involved in the adventures of the corporate.[389]

According to Edgar, the first best solution would be to apply a comprehensive accrual method to all instruments and to have shares subject to bifurcation as well, whereby every instrument is divided into a bet element (where the gain/loss is unexpected) and a time value element (where the gain/loss is expected), each part being tax separately.[390]

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[388] See also Hariton (1994).

[389] For example, as Polito rightly points out, not all shareholders are in the same position and not all creditors are enjoying the same protection from risk. Moreover, since not all companies are exposed to the same degree of risk, a shareholder of company A might be more protected from risk than a creditor of company B. Yet, based on the debt-equity distinction, the former will be taxed on the premise that he is exposed to greater risk than the latter, and vice versa. (Polito (1992). A similar position is taken by Hariton (1994) and Wood (1999).

[390] This proposal is further discussed in the following pages below.

However, while shares theoretically should be subject (at least partially) to an expected return based system together with other debt instruments, this is not possible as long as countries continue to adopt a corporation tax that imposes tax on the profits at the hands of the corporation.[391]

Edgar concludes that as a result of some barriers corporate income tax is not replaced with accretion or expected return taxation with respect to equity. Nonetheless, because some countries regard the corporate income tax as a proxy for an investor level tax on the share gains, this view underlines attempts by these countries to reduce the inconsistency between the treatment of equity and debt by the use of an imputation system that treats the corporate level tax as a withholding tax for the shareholders.[392]

Thus, a distinction is maintained in the tax treatment of equity instruments on one hand and of debt instruments on the other hand, even though economically some of these instruments might be similar one to another. The main feature of this different treatment is the deductibility of interest paid on debt and the lack of such deductibility for distributions paid on equity. As a result, if we have two instruments, one equity and one debt, that are perfect substitutes, the difference in treatment creates a potential for tax benefit at no cost.[393]

"*The perfect or near-perfect substitutability of debt and equity entails little or no efficiency cost, and only revenue loss; imperfect substitutability involves some sacrifice in the desired pattern of cash flows, and some efficiency costs.*

The substitutability of debt and equity is attractive solely because of the inconsistency in the tax treatment of expected returns on these two instruments."[394]

The problem is that the root to the distinction is based on a legal premise and lies in the "proprietary view" of the corporation. According to this view, the corporate enterprise is equated with the residual interest of the shareholders who are treated as the effective owners of the underlying assets whereas the debt holders are considered as outsiders.[395]

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[391] Edgar (2000) at 300-301. These barriers are beyond the scope of our discussion and are mentioned in Edgar (2000) at 301-302.
[392] Edgar (2000) at 302-303. Thus, debt is usually preferable where the combined tax at the shareholder and corporate levels is greater than the expected investor level tax on gains. When it is the opposite then equity is usually preferable.
[393] Polito (1992).
[394] Edgar (2000) at 298.
[395] Edgar (2000) at 39.

The alternatives to this approach are all based on the economic premise that the functions performed by debt and equity are very similar because both types provide a certain rate of return in exchange for the provision of capital to be used by the corporation.[396]

"In general, the expected return on shares is higher than the expected return on debt simply because the amount and timing of the cash flows from shares are subject to a greater degree of contractual contingency than are the amount and the timing of the cash flows from debt. Apart from this difference in degree of risk and the commensurate rate of return, debt and equity serve the same function economically, and conceptually there is no fundamental difference between them."[397]

Whereas debt has a predominantly time-value element with a limited upside and an assured minimum return, equity has a predominantly unexpected return element that is dependant on the company's performance. The upside is quite high but so is the downside and the risk for not receiving any return on the investment.[398]

This, however, blurs when financial instruments that combine elements of debt and equity are introduced. Whereas the basic difference between pure debt and pure equity is relatively clear, there are many other instruments that are located in the middle of the two extremes and this seemingly clear distinction is blurred.[399] For example, it seems clear that common voting shares are equity investments whereas a one-year loan carrying interest of 8% is a debt instrument. However, how should we classify a non-voting cumulative preference share? Will our classification change if the shares are also redeemable at the option of the holder after three years? Will our classification change, if, instead of being redeemable, the shares are convertible to common shares of the issuer company at the end of two years? Will it change if the conversion is to be made at the option of the issuing company or to shares of a third company unrelated to both the issuer and the holder of the preferred shares? Should a convertible debt instrument be accorded the same treatment as a bond that is issued with a call option or a warrant?

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396 This alternative approach also explains the existence of the expected return element in equity investment.
397 Edgar (2000) at 93.
398 Edgar (2000) at 93-94.
399 If we take the view supported by Edgar that both debt and equity are functionally similar to each other and are essentially comprised of the same elements, a bet element with a time value element, the boundary between the two groups lies in the degree and extent of each of the two basic elements in the final instrument. An instrument with a significant bet element and a restricted time value element would be closer to equity and vice versa. The problem, however, is once again, where to draw the line. Unless we adopt a single treatment to both groups, we are forced to draw a line, which is arbitrary and is likely to lead to discontinuities and arbitrage opportunities. In fact, as long as the distinction is a matter of degree, it will always be arbitrary. For the problem of line drawing in tax law – see generally Weisbach (1998-1999).

Moreover, if we adopt an economic approach to evaluation and classification of financial instruments, we imply that all other legal attributes of the instruments are irrelevant. Apart from the possible disadvantages of this approach, such an approach would represent a significant departure from existing standards. To the extent it is not fully adopted by all countries, it is likely to result in possibilities for unresolved double taxation as well as many opportunities for ITA.

A first best solution for the treatment of financial instruments would probably be one similar to the above-mentioned comprehensive accrual regime. This, however, is probably not a practical option and thus a distinction is drawn between debt and equity.[400]

In the light of the given distinction in the treatment and the exclusion of equity from the expected return or accretion tax basis, it is necessary to decide how and where to draw the line between equity and non-equity instruments. In the absence of a first best solution, however, the combination of an existing difficulty in rationalizing the different treatment of debt and equity together with the continuing innovation in the creation of new financial instrument that makes it harder to draw a clear line between debt and equity, appears to lead us to a distinction which is both technical and arbitrary.[401]

[400] This discussion is beyond the scope of this work. See generally, Edgar (2000) and Weisbach (1998-1999).
[401] Weisbach (1998-1999).

Hybrid Financial Instruments

> *"In the cross-border context, for example, hybrid instruments may secure a deduction in one jurisdiction without the inclusion of income in another jurisdiction, thereby reducing the cost of financing or enhancing return. They are often used by multinational corporations to maximize or optimize tax and financial positions and by investors to achieve higher yields. In general, hybrid instruments must be carefully structured and documented in order to secure the desired result under each reporting regime."*[402]

A HFI is defined as "*a financial instrument that has economic characteristics that are inconsistent, in whole or in part, with the classification implied by its legal form. Such an instrument may possess characteristics that are consistent with more than one tax classification, or that are not clearly consistent with any classification.*"[403]

Examples for such instruments are participating debt obligations that are debt obligations on one hand but allows participation in the profits (a clear equity characteristic) on the other hand, profits sharing instruments and contingent debt instruments that are debt instruments whose interest and principal payments are contingent on the business performance of the borrower.

As I discuss further below, most of the discussion with respect to HFIs is conducted at the domestic level where the arbitrary nature of the distinction between debt and equity together with the difference in their tax treatment challenge tax systems to deal with the classification of instruments that possess features of both debt and equity.

Since, however, HFI are at the borderline between debt and equity, they present taxpayers with planning opportunities also at the international level, as they are more easily adaptable to achieving an inconsistent tax characterization in two or more jurisdictions. While most tax systems accept the dichotomy in treatment between debt and equity, tax systems developed independently and created their own approach to distinguishing debt from equity and interest payments from dividend distributions. Where there are differences in the position of the

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402 Connors & Woll (2002).
403 Duncan (2000) at 22.

dividing line, such differences often result in a risk of double taxation or an opportunity for double non-taxation.

Reasons for using HFIs

HFIs may be issued for tax reasons but a significant number of them are actually issued for non-tax reasons.[404]

Madison, in his 1986 article, mentioned several non-tax reasons for corporations to issue HFIs. [405] Among these reasons, HFIs are a source for "cheap debt" because their equity features (including their convertibility) make them more attractive for holders and allow issuers to borrow at lower rates than the rate that would be required in the absence of such equity features. HFIs allow investors that are subject to certain regulatory constraints to invest, thus increasing the number of potential investors and raising the price of the HFI (the market segmentation theory).[406]

If, in addition to the equity features, the issuer is able to structure the instrument so that it would be classified inconsistently in two or more tax jurisdictions, an additional benefit would be achieved as a result of the lower tax that would be imposed on the instrument.

Sometimes, however, the use of HFIs can be a method for bridging the taxpayers' objectives in raising capital with the investors' objectives in seeking an investment.[407]

For example, taxpayers wish to avoid the (unfavorable) full or partial double taxation that is usually associated with equity investments while retaining other non-tax benefits associated with equity investments.[408] To the extent taxpayers are able, they will attempt to create HFIs that substitute for existing debt or equity instruments while obtaining the non-tax benefits that do not exist in the generic instruments.

A HFI may also be issued for pure tax reasons or for a combination of both tax and non-tax reasons. Although the direct reason is tax related, the overall motivation for entering into the

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[404] *Ibid.* Among the reasons used by the IFA general reporter are regulatory or accounting limitations and the desire to retain/achieve certain risk level.
[405] Madison (1983-1984) at 467.
[406] *Ibid*, at 467.
[407] Hariton (1994).
[408] For example, high credit rating. Issuing hybrids that allow the parties to enjoy the preferential tax treatment of debt finance while not suffering the low rating disadvantages usually associated with debt finance. To a certain extent, this ability is now restricted following recent financial scandals including the collapse of Enron.

transaction is to obtain lower cost finance and the method for achieving this goal is through optimal use of the tax systems.

At the international dimension, the most familiar tax reason is double benefits, the ability to use the advantages of both debt and equity characterization and in particular, the ability to receive equity treatment at the shareholder level (no tax or reduced tax) together with debt treatment at the corporate level (deduction for "interest" payments).

How to Deal with HFIs?[409]

Based on the assumption that this distinction in the treatment of debt and equity is not removed, it is necessary to decide how tax systems should approach and treat HFIs that basically combine both debt and equity features.

The difficulty in articulating a consistent and useful method for the distinction between debt and equity and for the taxation of hybrids is illustrated by Hariton,

"Characterization of hybrid instruments involves placing instruments on this continuum and drawing arbitrary lines. This is not an impossible task.....The difficulty lies in the fact that debt and equity evidence a relationship between two classes of investors in a corporate enterprise, and a creditor can be said to avoid business risk only in relation to another investor who participates in that risk. Any time characterization is based on such a relationship, one can get lost in an "infinite loop" where each investment appears to both more and less equity-like than the one to which it is being compared.... If the question is still "how much do investors participate in relation to other investors in the same business?" then I think the distinction between equity and debt still can be drawn along a graspable continuum, without getting lost in an infinite loop."[410]

With the integration and globalization of financial markets, given the insistence of different tax systems to maintain the distinction between debt and equity, it appears that an analysis of where exactly to draw the line should not be limited to the domestic level, dealing with each tax system separately, but has to be dealt with simultaneously at the inter-nation level, by coordinating among the different tax systems and their respective choices of policy.

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[409] For a discussion of the theoretical possibilities, see generally, Wood (1999), Edgar (2000); The practical application of this issue in the context of the US and UK tax legislation is discussed below (pp. 127-163).
[410] Hariton (1994) at 501-502.

In the absence of such cooperation, while it is possible that several discontinuities might be removed at the domestic level, such discontinuities are likely to remain at the inter-nation level.[411]

In the General Report to the 2000 IFA Congress dealing with the taxation of HFIs, the starting point was that "*all tax systems distinguish between different classes of financial instruments through the use of rules that are, at least at the margin, arbitrary.*"[412] [413]

However, as a recent survey of several countries established, the approach often differs from one country to another,

"Some countries assign primary importance to the legal form or financial accounting of an instrument in determining its classification for tax purposes. In others, the economic characteristics of the instrument can have equal or greater importance. Many countries combine elements of each approach. In some countries, the tax authorities may challenge the form that a taxpayer has adopted for a transaction, but the taxpayers are not similarly entitled to disavow their own form. In other countries, taxpayers may determine the tax treatment of a financial instrument by reference to its economic substance even if that substance is inconsistent with the form of what they have chosen."[414]

Tax neutrality requires that economically equivalent instruments be taxed in a similar way. The problem is, of course, to determine the level of equivalence that is required for two instruments to be taxed in a similar way and the level of difference that is required to justify different treatment.[415] In addition, once again possible conflicts may arise when two instruments represent equivalent economic substance but different legal rights.

Apart from the alternative of taxing debt and equity alike, either partly or completely,[416] thus eliminating the distinction, there appear to be several main alternative approaches to taxation the debt-equity distinction and taxing hybrid financial instruments. All these alternatives are based on the premise that, justified or not, the distinction and the resulting discontinuity will remain part of the tax system. The aim is to achieve the most efficient and consistent way of

[411] Moreover, it is quite possible that the domestic law is reformed with the aim of eliminating discontinuities at the domestic level thus creating new discontinuities at the international level.
[412] Duncan (2000) at 29.
[413] See also Edgar (2000) at 308. Arguably, in a first best setting, there would be no distinction in the tax treatment of debt and equity.
[414] Duncan (2000) *ibid.*
[415] Helminen (2004) at 57.
[416] These alternatives including the following: to tax debt like equity, to tax equity like debt, or allow some of the equity investments to be treated as debt thus only partially eliminating the difference in treatment. See generally, Edgar (2000) and Wood (1999).

taxing financial instruments. Among the many methods that have been suggested are the factors approach, the facts and circumstances approach, the bifurcation and the two-stage bifurcation and also the integration approach.[417]

To summarize the discussion so far, one can say the following: First, the distinction between debt and equity, while possibly justifiable in the past, becomes less and less justifiable in the present as the distinctions between debt and equity becomes blurred. Second, despite the above, tax systems continue to draw an arbitrary line between the debt and equity and to treat each group differently. There are different approaches to deal with the distinction between debt and equity. Even if the same approach is chosen, there is still more than one way of applying the same approach.[418] And in fact, as it is further discussed below, this distinction is approached differently in different countries.

The Identification of the Instrument

An essential step in the determination of the tax treatment of a given instrument is to identify the instrument.[419] For that purpose, it is necessary to determine what is the instrument and what is included as part of it. For example, if company X issues a preferred share and a forward contract to A, an investor. Should the preferred share and forward contract be treated each as separate instruments or should there be an integration of both instruments in the light of the similarity in the identity of the two parties. Another example is of a share with a warrant. Should the share be regarded as an instrument separated from the warrant?

The answer to this question is not always clear and tax systems approach this issue differently. Sometimes, even within the same system, different approaches are followed. For example, the US system applies both integration and bifurcation to certain financial instruments.[420] Similarly, the UK system tends to treat convertible debt as one instrument containing a debt instrument and an option to buy shares while treating debt instruments issued with warrants as two separate instruments. As a result, different treatment applies in these two cases.

[417] For a discussion of the bifurcation see generally Edgar (2000) Ch. 6; for a discussion of the two-stage bifurcation as well as some of the other above-mentioned methods, see Wood (1999).
[418] A good example is bifurcation that can be applied in different ways, each time resulting in a different outcome. See generally, Egdar (2000). Similarly, a factors approach may lead to different results if the weight and importance allocated to the different factors vary from one jurisdiction to another.
[419] This question is also crucial for the purposes of tax neutrality and tax equity as it represents the basis for the determination of whether similar instruments are treated similarly and different instruments are treated differently.
[420] For example, IRC §1059 treating a "short against the box" as a combined position, imposing constructive sale.

United Kingdom

General Overview

When we examine the differences between the treatment of debt and the treatment of equity, we realize that the UK system is relatively in line with our general discussion above. The fundamental difference between debt and equity, at least at the issuing company level is that interest on debt is allowable as a deduction whereas distribution that is usually associated with equity is not. Similarly, dividends are taxed mostly on a realization basis (when received by the shareholder) whereas interest payments may be taxed on an accrual or even mark to market basis. This interest can be either stated or unstated interest (for example, original issue discount).

In addition, interest income is usually taxable in the hands of the recipient as ordinary income under Schedule D case I or III whereas dividend income is either exempt in the case of UK resident corporate recipient or subject to tax as schedule F income in the hands of non-corporate recipient. Different provisions apply where a non-resident company makes the distribution to UK residents. Such distributions are generally subject to tax in the hands of the UK corporate or non-corporate recipient under Schedule D case V.[421]

Another important distinction between equity and debt is that equity holders are usually not entitled to any regular payment or to the repayment of their investment. At the same time, while an equity share may be subject to preferential tax rates when it is disposed of by its holder, upon such disposition, the selling shareholders usually pays tax on the undistributed profits as well. Thus, unless the share is disposed of or the undistributed profits are distributed to the shareholders, there is usually no tax imposed on these undistributed profits apart from the corporation tax imposed on the corporation itself.[422]

Nonetheless, despite the existence of this deferral as a result of the realization approach (the wait and see approach) that is adopted for the taxation of dividends, once the dividends are distributed such earnings are subject to an existence of double taxation, first time at the corporate level and second time at the shareholder level. Such double taxation does not exist in debt finance.

[421] Under Schedule D case I or case V.

[422] Today, following the enactment of the substantial shareholding legislation, if the investment qualifies as a substantial shareholding within the definition of the corporation tax legislation then the disposition is exempt from tax.

The underlying justification for the distinction between debt and equity appears to be the difference in the risk inherited in the instruments. Equity instruments have high degree of non-payment risk and the return is not guaranteed, as there is no obligation to pay dividends and the claims of shareholders are subordinated to the claims of all other creditors. Debt, on the other hand, is regarded as a lower risk investment offering a guaranteed return.[423]

From an issuer perspective, an important element is the deductibility of the interest payments. Under UK tax law, interest is deductible if the instrument is regarded as debt and unless there is another provision that denies the deductibility of the interest payment.

In determining the tax consequences of a given instrument for UK tax purposes, we are required to answer a two-part question. First, what is the appropriate character of the instrument and is it within the loan relationship regime. Second, what is the appropriate treatment of the payments made with respect to the instrument and should these payments be treated as equity distributions outside the loan relationship regime or as interest payments within the loan relationship regime?

Moreover, in certain circumstances as further described below,[424] even if the instrument is treated as debt, while the instrument itself is not recharacterized as equity, the payments associated might be recharacterized as "distributions" within the meaning of s.209. Thus, it is only the cash flow that is being recharacterized, while the instrument itself is kept as is, for all purposes.

The starting point in the analysis is with the legal characterization of the instrument. Once the legal characterization of the instrument has been established, the following questions have to be asked. First, is the instrument regarded as loan relationship? To the extent it is, then income paid on the instrument as well as income paid upon the disposal or maturity of the instrument are all treated based on the loan relationship rules. Second, to the extent the instrument is not regarded as a loan relationship, it is necessary to determine whether one of the specific provisions apply to it. If one of these provisions applies, then payments made on the instruments are treated under loan relationship but payments made upon the disposal of the instrument are usually taxed as capital gains. This would generally apply to convertible securities, index linked and asset linked securities. As part of Budget 2004, the government has announced its intention to amend the rules to include a bifurcation provision with respect

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[423] *Ibid.*

[424] See pp. 139-144 below.

to certain assets which contain a derivative element[425] into a loan relationships part and a derivative contracts part. The loan relationships part will be fully within the loan relationships rules. The derivative contract part will be taxed under the capital gains rules (where s.92 and s.93 apply today) while the index-linked element will be exempt.[426]

Third, even if the instrument is not within loan relationship and not covered by any of the specific provisions, although the instrument itself is treated under the capital gains tax rules, it is still possible for payments made on the instrument during its life to be classified as a "distribution" thus disallowed as a deduction for the payor.

The Loan Relationship Legislation[427]

The UK scheme of taxing capital finance is described is the following way

"All forms of corporate debt come within the loan relationship rules. Equity-linked finance only comes partly within the loan relationship rules. UK borrowers are obligated to account for liabilities under capital instruments in accordance with FRS 4 and FRS 5. There is no specific accounting standard covering debt assets. In general these will be recognized on the balance sheet at either cost (accrual basis) or fair value (MTM). In the former case recognition of profits and losses will be deferred until realization or some triggering event. In the latter case all value changes will go through the profits and loss account."[428]

The reasons for adopting the loan relationship rules are summarized by the Inland Revenue as follows,

"The idea behind the legislation was to move away from a rigid income/capital divide in the way in which taxation was applied to an approach which looked at the overall position, either the return received or the total outlay, and taxed or relieved that overall outcome. The legislation follows accountancy practice quite closely in recognising profits and expenditure."[429]

As Southern has commented,

[425] For example, convertibles and asset linked securities that are discussed below.
[426] Inland Revenue (2004) REV BN 25.
[427] See generally, Southern (2002).
[428] See generally, Southern (2002) at 93.
[429] Inland Revenue, CT12000 - Company Taxation Manual.

"It is a commonplace that the policy of this legislation is to keep within the capital gains regime gains on equity and equity-related instruments whilst bringing into the pure income regime debt and debt-based products. Hence debt is taxed on an income (accruals) basis, while equity is taxed on a capital gains (realization) basis. However, this statement tells us nothing whatsoever about whether, in any particular case, an instrument comes in part or as a whole within one regime or the other."[430]

In this respect the UK adopted two different methods for the taxation of hybrids: bifurcation and assimilation. In the former, the instrument is bifurcated into its different parts and each part is taxed as a separate instrument. In the latter, the entire instrument is brought within one category and taxed accordingly.[431]

Thus, while the loan relationship regime has removed the need for a capital / income distinction for instruments that are included within its scope, it is still not wide enough to cover all instruments and applies, with some exceptions, only to instruments that come within the definition of a "loan relationship" or to related transactions. This is in line with Edgar, who argues that as long as there is a separate tax imposed on the corporation's profits, there can be no comprehensive accrual.[432]

The first step is to determine the nature of the instrument based on its legal form, as opposed to accounting treatment or economic substance. It is generally accepted that when an instrument is referred to as a share for UK company law purposes, such characterization will be respected also for tax purposes.

The starting point is usually with the characterization accorded to the instrument under general commercial law, a characterization that in most cases is respected for tax purposes as well.

"There is no general rule to require debt to be recharacterized as equity for UK tax purposes, or vice versa. Thus, if an instrument is treated in law as share capital it will be treated as equity for UK tax purposes:"[433]

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[430] Southern (2000) at 256.
[431] Southern (2002) at 118.
[432]Edgar (2000). In essence, the UK system can be seen as adopting a definition of debt while anything that is outside the definition is taxed as equity.
[433] Connors & Woll, (2002) at 231.

In analyzing the legal form of an instrument we need to examine the rights and obligations that are associated with the instrument. For example, where the instrument is a share, a reference should be made to the articles of association of the company issuing the shares to ascertain these rights and obligations. It has been commented that in general and subject to two well-defined exceptions, the legal characterization given to the instrument by the parties shall be respected. First, in situations where the English Doctrine of a Sham applies. That is, where the parties call an instrument a share, for example, while they intend it to be debt.[434] The second exception is situations to which the Ramsay Doctrine applies.[435]

Is the Instrument within the loan relationship rules?

Once the character is determined, it is necessary to decide whether the interest is within the loan relationship rules. Loan relationship only applies with respect to companies that are subject to Corporation Tax in the UK.[436] A "loan relationship" is defined as including a money debt arising from a transaction that is regarded as a transaction for the lending of money.[437] This definition consists of two parts. First, the instrument has to be a "money debt". Second, if the first part is satisfied, then it should be established that the money debt is arising in a transaction that is regarded as a transaction for the lending of money.

A money debt is a debt that is or has been a debt to be settled by the payment of money or by the right to settlement under a debt, itself being a money debt. This definition includes also debt that has the option to be settled in that way, either by the election of the debtor or of the creditor.[438] A debt that results from rights conferred by shares cannot be treated as being issued in a transaction for the lending of money and therefore would be outside the scope of loan relations.[439]

An instrument that is not within the definition of "money debt", either because it is not regarded as a transaction for the lending of money[440] or because it is not a debt, is outside the loan relationship rules and subject to capital gains tax treatment. In certain circumstances, however, payments made with respect to that instrument may, nevertheless, be subject to

[434] As it was described by Diplock LJ in *Snook v. London & West Riding Investments, Ltd.* [1967] 1 All ER 518, 528: "*for acts or documents to be a "sham", with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the rights and obligations which they give the appearance of creating.*" See also recently, *Hitch v. Stone* [2001] STC 214.
[435] This exception, however, is relatively narrow and should not be regarded as a judicial rule of economic substance or of substance over form. A discussion of the *Ramsay* Principle is beyond the scope of this dissertation. In general, see Tiley (2003). See also VanderWolk (2002).
[436] S.80(1) FA 1996.
[437] S.81(1), (2) FA 1996 as amended by FA 2002 Sch 24, para 2. See also Southern (2002) at 31.
[438] S.81(2) FA 1996.
[439] S.81(4) FA 1996.
[440] For example, convertible securities or credit given on purchase.

different rules, due to the application of specific anti-avoidance legislation. This issue is further discussed below.

If the instrument is regarded as a "money debt", it is still necessary to establish that it is a transaction for the lending of money. If this condition is not satisfied, then only the payments of the instrument are to be included within the loan relationship rules, whereas any disposal of the instrument itself will be subject to the capital gains tax legislation.

The legislation contains a list of certain excluded instruments, which do not come within the loan relationship rules. Shares are usually outside the scope. Ordinary shares and also preference shares are usually outside the scope of loan relationship but permanent interest bearing shares in building societies are. As it was summarized by Southern, *"everything on the equity side of the debt/equity border is outside the loan relationship rules."*[441]

Instruments that are outside the Loan Relationship regime but are affected by its application

Three types of HFIs fall outside the loan relationship rules but the loan relationship rules are still applied to them. These are convertibles, asset-linked and index-linked securities.

Convertibles

A convertible security is basically a bond with an option for the holder to convert it into a pre-determined amount of shares in the issuing company, an option that adds equity characteristics to it. On conversion no consideration is paid to the issuing company and any subscription that is to be paid to the company by the holder is set off against the amount represented by the bond.[442]

On conversion the shares come completely within the capital gains provisions. The loan relationship regime does not apply in general to convertibles due to their quasi-equity characteristics, the future conversion into shares makes the instrument into a future equity, which puts them outside the scope of a "money debt". Nonetheless, this regime applies with

[441] Southern (2002) at 51. Thus, any instrument that represents pure equity interest in a company cannot be a loan relationship. Shares in a company, for example, is defined in FA 1996 in a way that share is deemed to be any share that may entitle its holder to receive distributions, thus including preference shares (CCH, Online Library, at para. 133-010 referring to FA 1996, s.103(1)). According to Southern, in the Inland Revenue's view, most debts, which are legally money debts, are intended to be covered in the definition of loan relationship. Thus, there should be no distinction between a simple debt on one hand and a debt issued as a company security on the other hand.(Southern (2002) at 42). See also CCH Online Library at para. 133-010 quoting to that effect the Inland Revenue press release regarding the original legislation (REV 21 of November 28, 1995).
[442] Southern (2002) at 118.

respect to all interest on the convertibles prior to the conversion and to all other profits and losses arising to the issuer (but not to the holder). The latter is subject to capital gains tax with respect to such profits or losses.[443]

The beneficial tax treatment of convertibles is summarized and explained by Southern,

"An investor in a s.92 security gets a beneficial tax treatment, because capital movements are taxed on a realisations basis under the capital gains tax rules, and taxation of the gain can be deferred indefinitely by a share exchange, or exempted under the rule for disposal of substantial shareholding. This stems from the basic philosophy underlying the loan relationship and derivative contacts rules, that equity-based returns are to be taxed under the capital gains rules, while debt-based returns are to be taxed under the income rules. Interest returns disguised as dividends or capital are to be taxed under the loan relationship rules. This is the reason for the change to the s.92 rules."[444]

According to the Inland Revenue, s.92 and s.92A FA 1996 are meant to ensure that companies are unable to manipulate the terms of the security to ensure that they get the most advantageous tax treatment.[445]

From a holder (creditor) perspective, if certain conditions are satisfied, the instrument does not come within the loan relationship regime and the capital gains tax shall apply. These conditions are the following:[446]

- The rights attached to the instrument include a provision that entitles the holder the right or option to acquire shares in the issuing company as a result of the conversion.[447] These shares are limited to "qualifying ordinary shares" or "mandatory convertible preference shares";[448]
- The instrument does not come within the definition of a "relevant discounted security" or an "excluded indexed security";[449]

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[443] Southern (2002) at 118-119.
[444] Southern (2002) at 120.
[445] Inland Revenue, CFM6100 - Taxing loan relationships: convertibles etc: introduction
[446] S.92 FA 1996 as amended by s.72 FA 2002;. In FA 2002 the section was amended and additional requirements were added thus limiting the advantageous treatment of s.92 to a more restricted group of instrument.
[447] S.92(1)(b) FA 1996.
[448] S.92(2)(bb) FA 1996; "Mandatory convertible preference shares" are defined as shares that must be converted within 24 hours from their acquisition into "qualified ordinary shares" which are shares that are either listed on a recognized stock exchange or shares in a holding or trading company and are shares that carry a right to dividend or other profit share in the company (this right cannot be a right only to a fixed rate of dividend) (see generally, Inland Revenue, CFM 6130).
[449] s.92(1)(d) FA 1996.

- Upon issuance of the instrument, there was more than a negligible likelihood that the rights to acquire shares would be exercised to a significant extent;[450]
- The right to acquire shares must be fully exercised so that it ends the creditor relationship that existed before. Cash is only allowable with respect to fractional shares entitlement not exceed 5% of the value of the shares;[451]
- The extent of share acquisition upon conversion is not determined by reference to cash value provided for in the provision or ascertainable by reference to its terms.[452]

In addition, the following two requirements have to be satisfied:

- At the time of issuance, there is no connection between the issuer and the holder of the convertible security.[453]
- The security cannot be a security whose disposal would fall to be a trading receipt in the hands of the holder.[454]

If the security satisfies all the above-mentioned requirements, then according to s.92(2) FA 1996, the preferential capital gains treatment shall apply and the only items to be taken into account under the loan relationship rules are the interest and any exchange gains and losses. All other items are outside the loan relationship rules and the conversion to equity is subject to a rollover relief.[455]

Thus, the pre-conversion interest payments made on the instrument will not enjoy the deferral and be taxed on the basis of loan relationship rules. The treatment of s.92 is regarded as very beneficial because it allows the taxpayer to enjoy the preferential capital gains rules with respect to most of the income. This preferential treatment, however, has led to many attempts by taxpayers to come within the scope of s.92 FA 1996. Extensive anti-avoidance legislation was added, narrowing the scope of s.92 and creating certain anomalies in the process.[456] For example, convertible securities (as defined in s.92) cannot be issued to connected persons; the conversion according to the convertible security must be made in full (i.e. debt must be fully converted) and the convertible security cannot give the shares a pre-determined value.

[450] S.92(1)(e) FA 1996.
[451] S.92(1)(ee) FA 1996.
[452] S.92(1)(c) FA 1996.
[453] S.92(1E) FA 1996, "connection" is defined by s.87(3) FA 1996.
[454] S.92(1)(f) FA 1996.
[455] S.132 FA 1996.
[456] Inland Revenue (2002) in Appendix 2d: Anti-Avoidance – Targeted Measures, Clause 9.

FA 2002 also added what is now s.92A FA 1996 that deals with the borrower and limits the debits that the borrower can bring into account.[457] For example, expenses with respect to issuing shares on conversion and with respect to acquiring shares to be offered in exchange of the security can no longer be brought into account by the borrower.[458]

With respect to any items that are treated as loan relationship, their ascertainment should be made based on an authorized accrual method.

Asset-linked Securities

Asset linked securities is another example of a quasi-equity type of instrument. This type of instruments is very similar to a regular loan or a bond issued by a company whereby the holder (Creditor) agreed to transfer a stated amount of money at the beginning of the period and to receive an amount at the end of the period (the principal). This principal is usually determined by reference to a chargeable asset.

According to the legislation, a security is deemed to be linked to a chargeable asset if the redemption price is calculated by reference to the change in the value of the chargeable asset i.e. if the calculation is a multiple of the nominal amount of principal by this change in value.[459]

In distinction from interest payments that are payments made for the time value of money, the payment in asset-linked securities does not represent that time value of money but rather the changes in the value of a chargeable asset over the period of the security. A chargeable asset is defined quite restrictively as either a interest in land or a qualifying ordinary share which includes all shares apart from fixed rate preference shares and non-participating shares.[460]

An asset-linked security is treated as securities within s.132 TCGA 1992 thus being within the capital gains tax rules.[461]

"*Where the return is fully linked to the changes in the value of an asset, the lender's position is the same as if it owned the asset. The lender risks a loss if the asset falls in value, but will*

[457] S.74(1) FA 2002.
[458] S.92A FA 1996, CF6170- Taxing loan relationships: convertibles etc: conditions for the borrower.
[459] S.93(6), (7) FA 1996.
[460] S.93(10) and (12A) respectively.
[461] This rule applies only to capital gains. With respect to losses, in order for the loss to be relieved it has to come within the debt on security rules.

benefit from any increase. FA 1996 recognises the 'capital type' risk of such loan relationships and, in certain circumstances, excludes profits or losses arising on them. The chargeable gains rules then apply to such profits and losses, although the loan relationships legislation applies to any interest payable or receivable."[462]

The scope of this provision is further limited by FA 2002 with the introduction of new s.93A dealing with guaranteed returns introduced by s.76 FA 2002. An interesting feature of this legislation is its integrative approach to taxation of the financial position.[463] In essence, the legislation provides that when an asset-linked security (which in itself, as discussed above, is subject to the capital gains provisions) is held together with another position, in a manner that is designed to produce the taxpayer with a guaranteed return, the two assets will be treated as one instrument. The rationale behind this provision is that capital gains treatment should not be extended to a taxpayer that in effect enjoys the same benefits of a debt i.e. risk-free, fixed guaranteed return on his investment. This rationale is evident in the wording of s.93A(3).[464]

This appears to be quite an unconventional approach taken by the UK legislator and that is for two main reasons.[465] First, the approach adopts an economic substance approach to the taxation of the financial position by comparing the instrument to a cash flow with similar economic attributes (a loan) and taxing it accordingly. Second, and more significantly, because it combines two separate positions taken by the same taxpayer and treats them as a single instrument taxed based on its economic (as opposed to its legal) substance. The effect of this provision is to take an otherwise equity instrument and classify it as a debt instrument.

As a result of this legislation, the position is taxed under FA 2002 schedule 26 para 6, as a derivative contract.

Warrants

As it is described above,[466] warrants are similar to long-term securitized call options. Warrants can be issued with bonds, securities (equity and debt) or with shares and entitle the holder the right to subscribe to either shares or bonds at a fixed price in the future.

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462 Inland Revenue, CFM5910 - Taxing loan relationships: asset-linked securities.
463 Cf. the new proposal in Budget 2004 to bifurcate instruments.
464 S.93A(3). This rationale was also mentioned by the Inland Revenue (Inland Revenue, CFM5925 - Taxing loan relationships: asset-linked securities: guaranteed return).
465 Cf. the formalistic approach taken in *Citibank Investment Ltd v. Griffin* [2000] STC 1010, discussed below in the context of warrants.
466 See pp. 120-121 above.

When a debt is issued with warrants it gives rise to two separate instruments, a debt instrument and a warrant. According to financial reporting standard such issue constitutes a debt and equity issue and requires the proceeds to be apportioned between them.[467]

For tax purposes, the treatment of the investment depends on whether it falls within the scope of s.92 FA1996 to be treated as a convertible security. In general, warrants issued with debt that do not come within the definition of convertible security are likely to be treated as two separate instruments, an option and a pure debt.[468] With warrants, the warrants are treated as separate from the debt instrument with which they are issued. Thus, capital gains treatment only applies to the warrants and not to the bonds or other debt instruments with which the warrants are issued. The court's formal approach in characterizing instruments is reflected in the decision in *Citibank Investment Ltd v. Griffin*,[469] where the court insisted in following the legal substance of the transaction and refused to recharacterize two sets of put and call options into one loan transaction.

The case involved an "equity box" tax planning whereby the taxpayer held a set of put options and a set of call options, both on the FSTE All Shares Index. The two sets of contracts were cash settled with the same exercise date. The two sets were also structured in a way in which the amount payable was predetermined if the two sets of options were payable on the same day.[470]

The narrow issue was whether a gain made on the "equity box" investment constitutes a capital gain on qualifying options or income. The Inland Revenue took the position that treating the two sets of options together, the investment was like a zero coupon bond giving rise to income that should be subject to tax as ordinary income on an accrual basis. It should be noted that the other party to the transaction was subject to tax on an accrual basis and was able to deduct the payments made on an accrual basis (as part of its trade).

The Special Commissioners took a formal view of the transaction and refused to re-characterize it as a loan.

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[467] Southern (2002) at 147 referring to FRS 4.
[468] For example, a warrant issued with a debt obligation may not qualify under s.92 FA 1996 if the option can be satisfied without using the option (i.e. making the conversion) or if the extent of share acquisition upon conversion is determined by reference to cash value provided for in the provision or ascertainable by reference to its terms. In these situations, s.92 will not apply.
[469] [2000] STC 1010.
[470] For an illustrative description of the facts – see Southern & Southern (2000).

"The legal analysis of the transaction reveals that they were options and not loans. It follows that the legal nature of the transaction to which it is sought to attach a tax consequence is still an option and not a loan. To recharacterise the two options as a loan would be to disregard the legal form and nature of the transaction and to go behind them to some supposed underlying substance."[471]

This firm view of the commissioners was justified by the form (the legal nature, in the words of the court) taken by the taxpayer, which included, among others, the use of an ISDA master agreement which is an agreement for the making of options and not for the making of loans.[472]

In dealing with the argument that the two sets of options were planned to be exercised together and that the transaction did not incur any risk for the taxpayer who basically "guaranteed" a pre-determined return for himself, the Special Commissioner, continued with their very formal legalistic approach and noted that,

"Mr. McCall argued that the transactions were not options because, taken together, they did not have the normal concomitants of options, namely choice and risk. However, statutory definition of qualifying option in the legislation makes no mention of choice and risk. Also, although the amount payable to the taxpayer company was predetermined if both options were exercised together, what was not predetermined was the amount payable under each option. That did depend on the operation of the share index. ***Although we have that the intention of the parties was that both options should be exercised together, there was always the possibility that one option could be assigned before exercise with the consent of International; accordingly, each option did have an independent existence."***[473]

As additional support for their position, the Special Commissioners pointed to provisions dealing with default under the agreements, provisions that were suitable for options and not for loan agreements.[474]

On appeal to the High Court, the Inland Revenue tried again to challenge the treatment of the transaction based on the *Ramsay* Principle and treat the transactions as one transaction outside the scope of qualified options, thus subject to ordinary income treatment. This challenge failed mainly because the court adopted a relatively narrow view of the *Ramsay*

[471] [2000] STC 1010 at para. 53.
[472] *Ibid*, at para. 54.
[473] *Ibid*, at para. 57 (emphasis added).
[474] *Ibid*, at para. 58.

Principle[475] and held that it is an exhaustive test, the satisfaction of the requirements set forth by the court in *Furniss v. Dawson* being a precondition for its application. These conditions were not satisfied in the case at hand – the absence of practical likelihood for the pre-planned events not taking place (the taxpayer could have terminated the position earlier) and the lack of steps with no commercial purpose made the *Ramsay* Principle inapplicable.[476]

Southern, commenting on the decision of the Special Commissioners, mentioned the significance of the decision to taxation of financial instruments[477]

"However, the same issues are directly relevant to the tax treatment of guaranteed equity bonds, where the insurance company issuing the bonds enters into a derivatives contract with a bank in order to provide the return needed to fund the bonds. The whole basis of this structure is that the return on the backing transaction will in the hands of the insurance company be taxed as a capital gain and not as income. Moreover, the case raises in a distinct, simple and inflexible form the basic issue, whether a cash-settled derivative requiring a substantial up-front payment is a loan relationship. At a fundamental level, the case asks the question: what is the nature of legal fact? To these questions, the Special Commissioners have produced penetrating and perceptive answers."[478]

S.209 Distributions

As it was discussed above,[479] apart for the existence of certain specified exceptions, the UK tax system does not often recharacterize an instrument in contrast with its legal form. Instead, alongside respecting the legal form of the instrument, tax laws may alter the tax consequences of a given instrument if it is believed that another treatment is more appropriate. For example, if a payment is made by a company to a debt security holder, it is possible for that payment to be characterized as a "distribution" instead of an "interest", if it believed that a distribution is the more appropriate characterization. In that way, the instrument does not loose its debt characterization. Since, however, the interest payments made with respect to the instrument are recharacterized as a "distribution", the issuer is unable to claim a deduction and the holder is treated as if he received a "distribution" as opposed to interest payment.

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[475] The court made reference to the test in *Furniss (Inspector of Taxes) v. Dawson* [1984] STC 153 where the tests for applying the principle were formulated.
[476] *Ibid.*
[477] The law regarding the specific tax planning that was discussed in this case was changed by later legislation.
[478] Southern & Southern (2000) at 665.
[479] See p. 128 above.

The method for disallowing the deduction of the interest is by regarding part or all of the interest payment as a "distribution" for UK tax purposes thus unallowable as a deduction. The rationale behind the legislation is two-fold. First, it seeks to preserve the integrity of the corporate-shareholder taxation by ensuring that payments would not go from the company to shareholders in disguised form thus avoiding the treatment of a "distribution" for tax purposes and debt/equity distinction. Second, it seeks to ensure that such distributions, being a capital payment, are not allowed as a deduction against the company's profits, thus reducing the company's tax liability. Our analysis is conducted at two different levels, the issuing company's level and whether the payment is allowed as a deduction and the level of the holder and whether the payment is treated as a distribution.

A distribution from one UK company to another company that is subject to corporation tax in the UK is not chargeable to corporation tax in the hands of the recipient.[480] It is, however, chargeable to income tax in the hands of a non-corporate recipient.

S.209(2) ITCA 1988 defines a "distribution" for the purposes of Corporation Tax Acts. As well as applying to cover conventional situations of dividend distributions (including capital dividends), s.209(2) is wide enough and covers situations whereby there is a distribution out of the assets of the company in respect of shares in the company which does not represent repayment of capital or is not made in exchange for new consideration.[481] In addition, s.209(2) also covers interest payments made on a security issued by the company that exceed the reasonable commercial rate.[482]

In all these situations, the effect of s.209(1) is to recharacterize the payment as a distribution. As a result, the tax treatment that applies is of a distribution from a company to its shareholder.

Another situation in which s.209 applies is to interest payments made by a thinly capitalized company.[483] In general, a company is regarded as being thinly capitalized if its debt:equity

[480] S. 208 ITCA 1988.
[481] S.209(2)(b) ITCA 1988.
[482] S.209(2)(d) ITCA 1988.
[483] According to s.209(2)(da), for the thin capitalization rules to apply, the following two conditions have to be satisfied:
The issuing company is a 75% subsidiary of the other company or both are 75% subsidiaries of a third company, and
All or part of the distribution represents an amount, which would not have been paid to the other company in the absence relations, arrangements, or other connection (apart from the securities in question).
If the two conditions are satisfied, then s.209(2)(da) applies and the payment (or part of it) is recharacterized as a distribution. 209(2)(da) does not apply with respect to situations that are already dealt with by other parts of s.209. In addition, s.209(2)(da) only applies with respect to payments made to companies that are not subject to UK corporation tax (s.212 ICTA 1988).

ratio is high. The Inland Revenue usually takes the position that any rate above a 1:1 rate is outside the reasonable range and thus interest paid by such companies are potentially subject to the thin capitalization rules. There is, however, no official safe harbor.

Looking only at s.209, it would appear that the provision applies with respect to all types of transactions, both domestic and cross-border. This, however, is modified by s.212, which effectively limits the application of s.209 to cross-border transactions. The legality of this provision has been doubtful and it became even more doubtful in the light of the 2002 ECJ decision in *Lankhorst-Hohorst.*[484] In that case the ECJ held that the German thin capitalization rules which treated German residents differently than non-residents was discriminatory and in violation of EC law.

Even prior to the decision, it was argued that the legislation stands in contrast to EC law and also possibly treaty law.[485]

As a result of the ECJ decision, in a recent technical note, the Inland Revenue has announced that legislation will abolish the thin capitalization rules and replace it with strict transfer pricing rules that would apply to both domestic and cross-border situations.[486]

Equity Notes

Another situation that is covered by s.209 is the issuance of equity notes. Prior to the legislation in 1992, equity notes were used for two distinct purposes. First, UK resident companies and financial institutions used this type of instrument when raising finance in the capital markets. Despite the possibility for inconsistent tax treatment, the long maturity period made such finance option less attractive. The second purpose in which equity notes were used was in financing controlled corporations resident in the UK. In that way, foreign parent companies, especially US residents, were able to finance their UK subsidiaries while also enjoying the tax advantage of obtaining a deduction in the UK without incurring a corresponding inclusion of the income in the foreign country of the holder.[487]

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[484] C-324/00; The UK government asked to be added as a party in this case.
[485] Tiley (2001) at 799.
[486] the only exceptions are medium-sized companies and small companies to which the transfer pricing rules would not apply. With respect to the former, the Inland Revenue may apply the rules in exceptional circumstances. This ability does not exist with respect to the latter.
[487] Edge (1992).

The second group was described by the Inland Revenues as "*a hybrid instrument which appears to be debt to the United Kingdom but equity in the United States.... A United Kingdom controlled group may also try to use the equity note to obtain a double deduction. Instead of a direct borrowing by the parent to fund, for example, new overseas investment, the borrowing may be made by a US subsidiary.*"[488]

Instruments from the first group had usually long maturity with restricted obligation to repay principal prior to maturity except for on liquidation and were super-subordinated being only narrowly above preference shares. Nonetheless, these instruments retained their debt nature under general law.[489] Applying S.209, absent special relations the only possible challenge could have come from the provision aimed at result-dependent instruments, which did not appear to apply to equity notes.[490]

As long as the notes issued between associated persons were issued on the same terms as notes issued to unrelated parties (the first group above), Edge was of the view that s.209 was not applicable as long as the thin capitalization rules were satisfied.[491]

The effect of this planning was, according to the Inland Revenue, a reduction in the tax bill and thus a loss in revenue in both the US and the UK.[492] A challenge was brought by the Inland Revenue against the use of equity notes between multinational companies. The Special Commissioners maintained the interest character of the payments made under the equity notes. They based their decision on two main grounds. First, the specific words of the applicable tax treaty did not prevent such payments from being interest. Second, the payments did not come with the scope of s.209.[493]

As a result, following a Special Commissioners' decision and to prevent a potential loss of up to £150 million per year, it was decided to counter this planning option through legislation. In the words of the Inland Revenue: "*To avoid a lengthy period of doubt in the event of the case going through the Courts, F2A92/S31 legislated specifically against the equity notes making an addition to the list of payments which are treated as distributions under ICTA88/S209.*"[494]

488 Inland Revenue – International Tax Handbook, para. 1249-1250.
489 Edge (1992).
490 Edge (1992) referring to s. 209(2)(e)(iii).
491 At that time the thin-capitalization rules were different from the current rules discussed above.
492 Inland Revenue, International Tax Handbook, para. 1250.
493 Edge (1992) at 10.
494 Inland Revenue, International Tax Handbook, para. 1251.

The legislation adopted was aimed only at the second type of equity notes, those issued by associated companies, associated companies being defined at a relative high threshold of 75%, targeting "*certain undated and long-dated debt instruments that were issued on an inter-company basis by United Kingdom resident companies to fund additional capital investments, to provide working capital or to re-finance existing bank facilities.*"[495] It left untouched equity notes that were issued to parties who were outside this definition. Yet, the rationale expressed was to prevent the exploitation of the inconsistency.

"*Those schemes which were identified exploited the asymmetry in the treatment of equity notes in the United Kingdom and in the United States. But the legislation to counter such schemes is written in general terms.... Basically it covers any lending which is perpetual, that is with no particular redemption date, or is very long-term loan (over 50 years). It also includes loans which, although they appear to be for a term of less than 50 years, are, at the instigation of the borrower, capable of becoming longer term or non-repayable loans.*"[496]

The legislation has, however, an additional important limitation imposed by s.212. The equity notes legislation only applies, despite its wide definition, in situations where the company holding the instrument is not within the charge to Corporation Tax.[497]

As it is possible to note from the section, the approach taken is independent of foreign law. While foreign law may be inconsistent in its application and result in an opposite characterization, the UK tax principles that determine the tax classification and treatment of the instruments (including s.209) are applied independently from foreign law. The end-result might be the same and the taxpayer would not be able to claim double benefits. Yet, this result is achieved by a "limited import" of part of criteria that is used in another country to characterize instruments (using the long maturity factor to characterize the payment on a debt instrument as a "distribution"). This was done only for the purpose of denying benefits although the instrument should be entitled to such benefits had the application been limited to the domestic approach only.[498]

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[495] Briffett (1992).
[496] Inland Revenue, International Tax Handbook, para. 1251.
[497] The same rule applies also with respect to the thin-capitalization rules mentioned above. In both cases, the original section is wide enough and covers both domestic and cross-border situation. However, S.212 restricts the application of these two sections only to cross-border situations. This approach is very interesting in the European context as it is likely, following the ECJ decision in *Lankhorst-hohorst* that similar legislation in the UK (as well as in the rest of Europe) would be under scrutiny. The way in which the legislation is structured, however, is quite interesting as it does not apply only to non-residents but rather to those taxpayers who are not within the tax charge of the Corporation Tax. It is to be seen if the ECJ would regard this as a covert discrimination or as a restriction on one of the freedoms of the Treaty of Rome, thus inconsistent with EC law (see further, our discussion of EC law in the context of s.209(2)(da) above (p.141)).
[498] One of the reasons for that is the inapplicability of the transfer-pricing provisions to equity notes. Transfer-pricing provisions usually seek to prevent shifting between two related taxpayers, usually from two different

The legislation was criticized for its reliance on US tax characterization of an instrument for determining the availability of the deduction in the UK[499] and for denying benefits for an instrument merely because of an inconsistent treatment in another jurisdiction.[500]

The above-mentioned reliance was made in direct contrast to the established principle that foreign tax law does not have any effect on UK tax law. In a question of UK tax characterization of foreign income or foreign entity, the decisions is made by applying UK tax principles while referring to foreign law (company law, for example, but not foreign tax law) to assist in the application of UK tax principles. Foreign tax law has no impact on the determination of UK tax liability.[501]

Treatment of foreign income – *Memec* and the availability of indirect foreign tax credit

The taxation of foreign income received by UK residents is determined by UK tax law based on a determination of the nature of the payment, which is made as a question fact and based on foreign law. Thus, in determining the UK tax consequences of a receipt that is received by a UK taxpayer the first step is to determine its nature and characteristics under the applicable foreign general law and then apply UK tax law to those characteristics to determine its UK tax treatment.[502]

In the context of foreign tax credit, the foreign tax credit is usually determined by reference to the tax treaty between the UK and the foreign country.

If a tax treaty applies than the foreign tax credit (including the indirect credit) is determined according to the provisions of that treaty. A few years ago, in *Memec*,[503] the Court of Appeal acknowledged the possibility of inconsistent treatment in the two relevant jurisdictions by holding that for the purpose of applying the indirect tax credit provision, the word "dividend" does not have the meaning as defined in the dividends article of the treaty but

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jurisdictions, shifting that would not have been possible but for the special relations. Transfer pricing does not apply when a less beneficial investment is chosen over another investment as long as the chosen investment is priced at arm's length. That has essentially happened with equity notes. This explains the argument raised by Edge (Edge (1992)) and I return to this issue in the analysis below (pp. 223-224).

[499] Briffett (1992).

[500] Edge (1992) at 13.

[501] See generally, *Inchyra v. Jennings* [1965] 42 TC 388, *Archer-Shee v. Garland* [1931] AC 212, *Baker v. Archer-Shee* [1927] AC 844, the discussion in Tiley (2000) ¶60.3 and in the next paragraph.

[502] See generally, *In Reid's Trustees* (1949) 30 TC 431.

[503] *Memec plc v. IRC* [1998] STC 754.

rather the definition of the country applying the treaty which in that case was the country of residence, the UK.

Following the decision in *Memec*[504] and the practice in the area of double tax relief, it appears that, in the absence of a clear provision to the contrary, a UK resident company receiving an income payment on a HFI from a foreign company should be able to receive both the tax credit with respect to any withholding taxes paid by the foreign payor[505] and the indirect tax credit with respect to that income as if it was a dividend payment provided the income is treated as dividend under UK tax laws, even if it is not classified as a dividend in the country of the payor.[506]

For example, in the 2001 US-UK tax treaty, the foreign tax relief provision was structured to disallow indirect foreign tax credit in certain situations. This special rule can serve as an additional support for the view that in the absence of a clear provision to contrary, the indirect foreign tax credit should be available if the receipt is classified as a dividend in the country of residence.

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[504] *Ibid.*

[505] In this case, according to the practice that now is also included in the OECD commentary the country of source applies the treaty and determines the applicable provision based on the character of the income under the treaty (and if necessary under its tax law). The country of residence in applying the direct tax relief provision accepts and follows the characterization given in the country of source, even if such characterization is contrary to the characterization that would have been given under the laws of the country of residence in the absence of a treaty.

[506] See also, Avery Jones et al (1999) and Avery Jones et al. (1996).

United States

The US takes a different approach to the distinction between debt and equity.[507] In general, the issues are quite similar. In the US, as it is in the UK, debt finance has advantages over equity finance. For many years, the US has followed the classical system of taxation of corporations, which meant that the profits of the corporation were taxed twice, once at the corporate level and then once again at the shareholder level. This has changed in 2003, with the introduction of a partial dividend exclusion as part of the Jobs and Growth Tax Relief Reconciliation Act 2003.[508] The new legislation applies with respect to US corporations distributing a dividend to US resident individuals and with respect to qualified foreign corporations distributing dividends to US resident individuals.[509] This change in the law made it much more beneficial for US resident individual shareholders to invest in equity than it used to be under the classic system.[510]

If the payment is classified as either a distribution other than a dividend or as an interest payment, then this payment is subject to tax.[511] In the former case, it is usually taxed as capital gains possibly subject to preferential tax rate, while in the latter case; it is taxed as income according to the marginal income tax rate of the recipient.

With respect to corporate shareholders, as long as the shareholder is a US resident corporation and the distributing corporation is a US corporation, partial or full exemption may be allowed with respect to inter-company dividend distributions.[512]
If, however, the payment is classified as a distribution other than a dividend or as an interest payment than it shall be subject to tax in the hands of the receiving corporation.

At the issuing corporation level, there is a general preference on part of taxpayers towards interest characterization mainly due to the deductibility of these payments in the calculation of the corporation's profits.

[507] There has been extensive writing on the topic. See generally, Bittker & Eustice, Bittker & Lokken, Conlon & Aquilino (2001); (Plumb (1970-1971) and Freeman et al (2002).
[508] Pub. L. 108-27.
[509] For non-US resident individual shareholders, the existing treaty withholding taxes still apply.
[510] This change is, however, limited in time and is expected to sunset in 2008.
[511] IRC §316 defines a dividend. In addition, there is a complex and well-developed legislation that attempts to prevent certain distributions from enjoying a beneficial capital gains treatment by avoiding the dividends treatment (§302-307).
[512] IRC §243.

In the following pages I describe the approach taken in the US with respect to other classification of instruments, an approach, best described as a factors approach, that was challenged and as a result has been developed mainly a purely domestic context.

A good way to start the discussion of this complex part of the law that is currently governed mainly by a labyrinth of not always consistent case law and IRS pronouncements and rulings, is to use the following passage by Plumb that was written in 1971 and is still very relevant today,

"In many ways – some obvious and well known, others more subtle – the federal tax law draws a sharp distinction between the tax consequences of debt and of stock, of interest and of dividends; but it provides no definitions of those concepts. The Supreme Court once said that such terms are "well understood" and "need no further definition"; but a "jungle" of several hundreds court decisions which "defy symmetry" have, in the ensuing quarter century, proved the error of that assumption. The Supreme Court has declined every subsequent opportunity to clarify (or perhaps to add to) the confusion, and proposals of several prestigious groups for the amendment of the statute have found no support in Congress. Now the Congress has passed the ball to the Treasury, with a broad authorization to establish, by regulations, standards for distinguishing debt from stock for all purposes of the Internal Revenue Code."[513]

Since then, with the above-mentioned grant of authority resulting in proposed regulations that were subsequently withdrawn, the confusing state of the law is still the same if not worse, due to the addition of some new case decisions and administrative rulings over the last thirty some years. Nonetheless, Plumb's analysis is still relevant today. In the following few pages, I shall try to briefly discuss the outstanding issues as they stand today.

The authority under §385

The starting point is §385, which was first added to the Code in 1969. Although case law existed well before its introduction and has continued to exist with no less importance during the thirty-plus years that have passed since, it is impossible to truly understand the state of the law in this area without understanding first this statutory provision and the failed attempts over the years to introduce regulations to govern the classification of instruments for tax purposes.

[513] Plumb (1970-1971) at 369.

§385(a) provides as follows

"The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)."[514]

Section 385(b) provides for factors that should be considered, among others, as part of a facts and circumstances test in determining the nature and character of the instrument. These factors are:

"(1) Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
(2) Whether there is subordination to or preference over any indebtedness of the corporation,
(3) The ratio of debt to equity of the corporation,
(4) Whether there is convertibility into the stock of the corporation, and
(5) The relationship between holdings of stock in the corporation and holdings of the interest in question."[515]

In 1989 §385 was amended to include a provision whereby a characterization that is given to an instrument by its issuer shall be binding on its holders unless the latter notify the Commissioner that they do not accept the characterization given by the issuer.[516] Thus, theoretically, with a proper notice, there is no prohibition on the holder to adopt a characterization that is different from the one adopted by the issuer.

In 1980 pursuing the authority granted by §385, the Treasury issued proposed regulations for the classification of instruments in an attempt to replace to the case law facts and circumstances test with a more precise mechanical test. According to the proposed regulations, the "all or nothing" approach was maintained but the multiple factors case law test was replaced by a quantative bright-line test whereby a hybrid is classified as debt if 50% or more of its fair value is represented by debt features. Alternatively, an instrument is

[514] IRC §385(a).
[515] IRC §385(b).
[516] IRC §385(c).

classified as equity if the value of the equity factors exceeds 50% of the value of the entire instrument.[517]

As a result of these regulations, taxpayers and their advisers began to plan their affairs so that they manage to qualify within the provisions of the proposed regulations. One of these attempts was the creation of "adjustable rate convertible notes" (ARCN) which bore interest at below market rate but offered additional interest payments based by reference to dividends paid by the issuing company on its stock. Additional features of the ARCN were a conversion to common stock of the issuer at a conversion rate that was equal to the then market value of the shares and redemption at a price below issue price. The combined effect of these two features was to almost enforce conversion to common shares of the issuer.[518] The link to the proposed regulations was in an analysis that was prepared by the investment bankers according to which 55% of the value of the ARCN was derived from their debt features and only 45% of their value was derived from their equity feature. Thus, applying the bright-line test of the regulations, ARCN were to be classified as debt. The IRS dealt with this issue first in *Revenue Ruling 83-98* and then by withdrawing the proposed regulations. In *Revenue Ruling 83-98* the IRS analyzed the tax treatment of an ARCN and found it to be equity based on the analysis that most of the value of the ARCN is attributable to equity features.[519]

Nonetheless, despite the conclusion in the ruling, the Treasury decided to withdraw the proposed regulations that provided taxpayers with planning flexibility.

"In course of dealing with ARCNs, the Treasury Department became aware that it was fighting a losing battle. The 'bright-lines' in the Section 385 Regulations provided rules that the Service could utilize in testing whether an instrument was debt or equity, but they also provided taxpayers (and their advisors) with a playing field on which instruments with significant equity characteristics could easily be classified as debt for tax purposes. The possibility of increased interest deductions under Section 385 Regulations seriously jeopardized the fisc."[520]

Following the ACRNs and the withdrawal of the proposed regulations, debt:equity debate arose again with respect to the issuance of the MIPS (monthly interest preferred stock). The interesting point regarding the issuance of MIPS is with respect to the reasoning behind it

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517 Freeman et al (2002) at 654.
518 *Ibid.*
519 Freeman et al (2002) at 658.
520 *Ibid.*

"The MIPS structure is, in reality, more of a GAAP accounting and rating agency play than it is a tax play, but, unfortunately, it was billed as a tax play by the general financial press and, therefore, the Treasury department reacted to it."[521]

The MIPS structure[522] is comprised of a partnership or an LLC used as a special purpose vehicle and is transparent and classified as a partnership for US Federal income tax purposes (Although different classification as a wholly owned subsidiary is given for corporate law and local tax purposes). The LLC issues preferred interests to the public for cash. The preferred interests are dividend yielding. The money raised on the issuance is loaned to the company and the latter is then paying interest on the loan. Because of the transparent (partnership) classification of the LLC, the interest income paid by the company on the loan is attributed to its interest holders which is the public that hold a majority interest following the issuance of the MIPS. Thus, for tax purposes, we have a loan from the public to the company. At the same time, for accounting and rating agencies purposes the transaction is viewed as an minority interest issuance by an affiliate and thus recorded on the balance sheet as an issuance of shares by a subsidiary and not as debt, making the balance sheet look much healthier from the company's perspective.

The Service did not perceive it that way and responded in *Notice 94-47* and *Notice 94-48*.[523]

The Service was concerned with two equity features that were associated with hybrids that were classified by taxpayers as debt. These features were relatively long maturity (based on the decision in *Monon Railroad v. Commissioner*[524] which classified an instrument with a maturity date of 50 years as debt) and repayment of the debt with shares of the borrower. At the same time, the Service tried to maintain the general approach whereby all factors have similar importance in the classification of financial instruments, none of them being controlling and classification should made on a case-by-case basis taking into account this approach. This resulted in a confusing and sometime contradictory notice.[525]

The notice starts by stating its aim, to scrutinize instruments that are classified as debt for tax purposes and as equity for other purposes, for example, regulatory or rating purposes, and adding that "*[O]f particular interest to the Service are instruments that contain a variety of*

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[521] Freeman at 667.
[522] The following description is based on Freeman at 668.
[523] 1994-1 C.B. 357; One reason for the issuance of the notice was the reliance by taxpayers on a previous notice, Notice 85-119, which was applied by taxpayers without giving sufficient attention to its particular facts.
[524] 55 T.C. 345 (1970).
[525] Hariton (1994) at 505.

equity features, including an unreasonably long maturity or an ability to repay the instrument's principal with the issuer's stock."[526]

The notice then briefly review the facts and circumstances test applicable in classifying instruments. In its overview the notice mentions a list of examples for factors that are used in the application of the facts and circumstances test. Interesting to note is the last factor mentioned on that list, "whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes."

Then, the notice provides, in apparent contradiction with its stated aim, that *"[N]o particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. The weight given to any factor depends upon all the facts and circumstances and the overall effect of an instrument's debt and equity features must be taken into account."*[527]

This does not prevent it from changing approach and focusing again only on unreasonably long maturity and ability to replay with issuer stock.[528]

Hariton criticizes not only the notice but also the approach. He comments on the self-contradictory and unhelpful approach of the Notice[529] and argues that the analysis of whether a given instrument is debt or equity cannot be made while including factors as the instrument's non-tax classification or its label.[530] According to his view, the analysis should not be made following a checklist but rather by examining the relationship among the different type of classes and holders within the same corporation.[531] He disagrees with the formula approach or with the factors approach to classification and adds that a revenue guidance explaining why in their view a specific instrument should be classified in a particular way would be beneficial.

Hariton concludes that *"[T]he new financial environment merely emphasized what was always true: One cannot draw this line by searching for characteristic attributes. Rather,*

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[526] *Notice 94-47* at 357 quoted by Hariton (1994) at 503.
[527] 1994-1 C.B. 357.
[528] See also Hariton's criticism on this contradictory nature of the notice.
[529] On one hand, the Notice provides that the two above-mentioned factors are controlling and on the other hand it argues that for a factors approach, all factors being relevant and no specific weight is attributed to either one. The self-contradiction can be illustrated by using an instrument which has all the necessary debt features with only one equity feature, very long maturity date. Based on the Notice, would such an instrument be classified as equity only due to its long maturity? Compare to the approach adopted by the courts below (pp. 153-156).
[530] Hariton (1994) at 521.
[531] Hariton (1994) at 522.

one must analyze the relevant facts with a view to understanding the corporate structure and how the particular investment fits in."[532]

In a few relatively recent IRS decisions, the Service has accepted a characterization of an instrument that was inconsistent with its foreign law characterization. Thus, in *I.L.M 200134004*,[533] the Service accepted a characterization of an instrument as equity for US tax purposes although the instrument was characterized as debt for foreign law tax purposes. Similarly, in *FSA 200142005*,[534] the Service accepted the taxpayer's position that a transaction that is characterized as a loan stock for Australian tax purposes, should be characterized as an equity for US tax purposes, and in *FSA 200145005*,[535] the Service accepted that a debt that was paid solely in shares of the issuer (voting common shares) should not be treated as debt despite the fact that the issuer was able to deduct the payments made on the debt.[536] In addition, in *FSA 199922012*,[537] the IRS concluded that notes issued by a US subsidiary (together with cash) to its foreign parent company in exchange for redemption by that company of shares of the issuing company, should be treated as debt. The focus was on the ability of the taxpayer (the US subsidiary) to borrow from unrelated third parties for the purpose of redeeming its stock on similar terms to the terms of the notes, and the existence of sufficient cash flow to service the debt on the notes.[538]

Thus, basically, the Service seems to agree that in determining the characterization of the instrument for US tax purposes, it is US tax law that should apply to determine the characterization and the characterization under foreign law should not be taken into account. More precisely, it appears that the Service did not treat a consistent characterization as a condition in the characterization of an instrument and accepted that possibility of inconsistent characterization. This, however, is subject to certain limitations that were imposed by the courts on the taxpayer's ability to choose the character of the transaction, limitations that increase the importance of the form in determining the tax treatment of the instrument. These limitations are discussed below.

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532 Hariton (1994) at 524.
533 2001 WL 961299 (IRS CCA).
534 2001 WL 1250258 (IRS FSA).
535 2001 WL 1402895 (IRS FSA).
536 Although, as Connors and Woll note it was not characterized as equity either (Connors & Woll (2002) fn. 24).
537 1999 WL 358204 (IRS FSA).
538 Blessing (2002) at 1009.

Case Law

Plumb in his seminal article describes the difference between a shareholder and a creditor as follows

"The 'vital difference between the shareholder and the creditor,' it was said in an early case is that the 'shareholder is an adventurer in the corporate business; he takes the risk, and the profits of success, the creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into capital when the payment date arrives.' 'The classic debt' is said to be 'an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or the lack thereof. While some variation from this formula is not fatal to the taxpayer's effort to have the advance treated as a debt for tax purposes... too great a variation will of course preclude such treatment.'"[539]

He then moves on to define a hybrid instrument and to discuss the way in which the courts are attempting to classify this hybrids, despite the very close resemblance of some hybrids are to other instruments, as for example, cumulative preferred stock.

"Nonetheless, the courts, focusing primarily on the four corners of the instrument, undertook, by a process of "minute comparison of, and effort to differentiate, the multitudinous microscopic details," to draw the distinction that the law required to be made."[540]

Plumb names thirty-two different factors, divided into four different groups that are applied by the courts in such determination. Over the years, the courts have used a selection of these factors on a case-by-case basis, the type of factors and their relative weight in the decisions changing from one case to the other and from one court to the other.[541]

According to two leading commentators, *"[T]he expectation of the parties that a security will provide for a timely repayment of principal, plus a reasonable rate of return, subject to*

[539] Plumb (1970-1) at 404.
[540] *Ibid.*
[541] Plumb divided them into four different groups: first, factors that involve the formal rights and remedies of creditor as distinguished from those of shareholders. Second, factors whose existence has a bearing on the genuineness of the intention to create a debtor-creditor relationship. Third, factors whose existing has a bearing on the reasonableness or the economic reality of the intention (also referred to by Plumb as the risk factor). Fourth, factors that have no proper evidentiary weight of them but are described as being "merely rhetorical expressions of a result". (See Plumb (1970-1971) at 411-412).

limited contingencies, is consistent with the treatment of the security as debt. The lower such expectation, the less certain debt characterization would be appropriate."[542]

While a comprehensive analysis of the case law is beyond the scope of this work, a brief overview of it together with the reference to Plumb's article above, allows us to get a flavor of the different factors commonly used by the courts in their analysis.[543]

In *Nestle Holdings v. Commissioner,*[544] a transfer of funds was made from a foreign parent to its US subsidiary and the question was whether these funds should be respected as debt or recharcterized as equity.[545] The Tax Court respected the debt characterization and allowed the interest expense despite the inconsistent reporting by the taxpayer to the SEC. The following factors supported the decision: the taxpayer was able to establish an objective evidence of an intent to create a debtor-creditor relationship; there were reasonable projections that supported the repayment of both the interest and the principal; a timely repayment of both interest and principal was established; the taxpayer was able to borrow on similar terms from unrelated third party financial institutions; the related party debt was reduced in the following years.[546] This last point allowed the court to attribute less significance to the fact that the return of the loan depended to a large extent on the success of the acquired asset.[547] The decision was reached despite the fact that the funds were used to purchase a capital asset, the use of debt financing (as opposed to equity financing) was due to tax considerations, and the taxpayer's debt:equity ratio was relatively high in comparison to the industry.[548]

The Tax Court in *Full Service Beverage v. Commissioner*[549] imposed a strong limitation on taxpayers' ability to use HFIs with inconsistent classification. In that case, the taxpayer sought to recharacterize preferred shares as debt. The taxpayer based his claim on the special characteristics of the shares, which paid dividends without reference to the profits of the company, dividends which were paid on specific dates and if not paid incurred interest. In addition, the shares had a fixed date of redemption.[550] The court based its decision on the

[542] Conlon & Aquilino (2002) at ¶B2.04[2].
[543] According to many, Plumb's article is the starting point for most attorneys dealing with this area of the law. An analysis based on the article and some of the more significant recent cases, is sufficient to establish the approach taken by the courts in this field (see generally, Conlon & Aquilino (2002) at ¶B2.04[1]).
[544] T.C. Memo. 1995-441.
[545] Connors & Woll (2002) at 184.
[546] Blessing (2002) at 1006.
[547] Connors, *ibid.*
[548] Blessing (2002) *ibid.* but note Connors who comments that the court found the taxpayer not to be thinly capitalized.
[549] T.C. Memo. 1995-126.
[550] Connors & Woll (2002) at 185.

form of the instrument, the fact it was the form chosen by the taxpayer, the consistent treatment of the instrument by the taxpayer as equity, the fact that some rights of the holders were subordinated to rights of creditors (reference was made to the rights on dissolution) and that the holders have participation right in the management of the company.[551]

Moreover, it appears that even if the taxpayer was able to establish that the instrument was more likely than not debt, it would not be sufficient and a strong proof (based on the requirement in *Coleman v. Commissioner*) would be required to persuade the court to disregard the form and follow the substance of the instrument on an application by the taxpayer.[552] It appears that in these situations, to be able to enjoy a debt characterization, the taxpayer is required to satisfy the stricter *Danielson* strong proof test, although it is questionable to what extent, if at all, the court will be willing to accept a debt characterization when the instrument in question is in the form of a share.

These rules represent important exceptions to the general approach of economic substance where the taxpayer is limited to the choice of the form of the transaction. These rules of the courts limit, in practice, taxpayers' ability to choose the economic substance of the transaction (instead of its form) and represent an important restraint on the availability of ITA.

In *Estate of Mixon v. Commissioner*,[553] the Court of Appeals for the 5th Circuit used 13 factors in its determination. These factors were the following: the name given to the certificates evidencing the indebtness, the presence or absence of a fixed maturity date, the source of payments, the right to enforce payments of principal and interest, participation in the management of the issuer, the status of the holders in relation to regular corporate creditors, the leverage of the issuing company, the intent of the parties, the source of the interest payments, the identity of interest between the parties (i.e. whether they have a common objective or conflicting interests), whether the issuing company is able to obtain loans from unrelated third parties outside the lending institutions, the failure of the debtor to pay on due date, and the purpose of the use of the funds – the extent to which they were used to acquire capital assets.[554]

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551 *Ibid.*
552 *Ibid.* In *Taiyo Hawaii Co. v. Commissioner*, the court required a consistent use of the substance of the instrument by the taxpayer in order for it to accept a claim to disregard the form in favor of the substance.
553 464 F2d 394 (5th Cir. 1972).
554 At 402.

More recently, in *Laidlaw v. Commissioner*,[555] the Tax Court, relying mostly on the decision of the Court of Appeals for the 5th Circuit, mentioned that although the instrument was debt in its form, according to the above-mentioned factors of *Estate of Mixon*,[556] the instrument should be characterized as equity. Among the factors applied more significance was attributed to the lack of principal payment, the circularity of the money used to pay the interest payments, the high leverage of the issuer and to the later change of the instrument to debt payable upon demand.[557] It should be remembered, however, that the decision was influenced to a large extent by the failure of the taxpayer to introduce supporting documentation.

Statutory Provisions

The statutory provisions in this area can be divided into two groups. The first, statutory provisions dealing with the question of interest deductibility. Second, statutory provisions dealing with the availability of Dividend Received Deduction (DRD). Both the interest deduction and the DRD represent an important benefit associated with the desired finance method that allows the two parties to reduce, fully or partially, the double taxation burden.

In an equity investment, the availability of DRD means that the company treated as the shareholder will be able to enjoy full or partial exemption from taxation with respect to dividends income it receives, thus remove, even if partially, the risk of double taxation. In a cross-border transaction, the DRD is replaced, in most situations, with an indirect foreign tax credit that is available to corporate shareholders holding 10% of the voting shares of the issuing corporation.[558]

In debt financing, the availability of the interest expense at the borrower's corporation level, allow the parties to avoid the double taxation as the recipient of the interest income is usually taxed with respect to that income.

To achieve the benefit of double non-taxation (both domestically and cross-border), the taxpayer would seek to structure the transaction in a way that it would provide the issuer with the full interest expense and will not be included in the taxable income of the holder (for example, by allowing the holder to enjoy indirect foreign tax credit that would reduce his domestic tax liability).

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[555] RIA TC Memo ¶ 98,232 (1998).
[556] *Ibid.*
[557] *Ibid.*
[558] IRC §902.

In the following paragraphs I will deal with the domestic rules regarding the deductibility of interest expense with respect to both domestic and cross-border payments. Following this, I will turn to deal with cross-border anti-planning legislation.

The Deductibility of interest

One of the main benefits associated with a debt classification for tax purposes is the deductibility of the interest payments as an expense in the calculation of the borrowers taxable income. A possible way of discouraging the use of a particular instrument without altering its tax characterization is by disallowing the benefit of deduction to the payments made on this instrument.

§163(a) allows taxpayers to deduct interest expenses from their taxable income. For the expense to be deductible, it has to satisfy three cumulative conditions: it has to be an interest, it has to be paid or accrued in the taxable year and with respect to indebtness.[559] There is extensive case law on the meaning of both interest and indebness and how to distinguish these two terms from many similar concepts.[560] In addition, there are several statutory provisions that are designed to assist in that process and to limit the application of the section only to payments that the legislator believed come within the definition of interest on indebtness.[561]

Interest was defined by the Supreme Court as a "*compensation for the use or forbearance of money,*"[562] taking outside the scope of the provision payments that are not compensating for the use or lack of use of money.

In addition, special rules were enacted to deal with payments made on certain instruments and with respect to certain transactions, even if such payments were in essence interest payments that, but for the statutory prohibition, would qualify for a deduction under §163(a). According to Bittker and Lokken, the restrictions on the broad grant of deductions by §163(a) "*have accumulated gradually but relentlessly over the years. The earliest of the restrictions, now found in s.265(a)(2), disallows interest on indebtness incurred or continued to purchase or carry tax-exempt bonds. The common sense basis for this rule – that the*

[559] IRC §163(a) ("*all interest paid or accrued within the taxable year on indebtness.*").
[560] For an overview of the issues and case law, see generally Bittker & Lokken, at Ch. 52.
[561] For a list of the statutory provisions, see generally, Bittker & Lokken, ¶52.1.1. The discussion below is limited to a brief overview of the provisions that are more related to our general discussion, the distinction between debt and equity and the availability of interest deduction on HFIs.
[562] *Deputy v. Du Pont*, 308 US 488, 498 referred to by Bittker & Lokken at ¶52.1.2.

interest should not be deductible because it is a cost of producing income that is exempt from tax – is also the root of the subsequently enacted limitations."[563]

Among these statutory limitations are denial of the deduction of interest on some unregistered debt instruments, denial of the deduction of interest on obligations payable in equity, and denial of deduction of interest on a debt instrument that is in substance equity.[564]

According to §163(l), interest paid on a disqualified debt instrument is disallowed in deduction. A disqualified instrument is an instrument issued by a corporation and payable in equity of the issuer or a related party. In general, to satisfy the requirements, a significant amount of the principal or interest has to be payable in equity either through a right of conversion to shares of the issuer that is included in the instrument or through an option for payment in equity exercised at the option of the issuer. Where the option for payment in equity is exercised at the option of the holder, the instrument may still be regarded as "payable in equity" if it is substantially certain that the option will be exercised. On the other hand, even if the conversion is at the option of the issuer, the instrument may nevertheless not qualify if the conversion price is substantially higher than the market price of the issuer's shares.[565]

In addition, according to §163(j), interest expense is denied, wholly or partially, if the interest is paid to a related person and the paying corporation is regarded as leveraged (the payor's debt: Equity ration of more than 1.5:1 and the payor's net interest expense exceeds 50% of its "adjustable taxable income"). Similar rules apply with respect to payments to unrelated persons where such persons are exempt from US Federal tax (for example, non-residents).

This rule also referred to as "earning stripping rule" was introduced in 1989 and was subject to a legislative debate in 2003 when proposals to amend it were introduced. The proposals were part of the move to make inversions transactions less beneficial for taxpayers who engage in them. The New York State Bar Association described the different proposals as follows: *"The proposals would significantly expand the current earning stripping rules by deleting or modifying the existing debt-to-equity safe harbor, modifying the substantially*

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[563] At ¶52.2.1. Later in their analysis the commentators criticized the use of denial of interest expense as being inappropriate in the light of the policy goals behind the exemption of interest on bonds issued by state and local authorities (see generally, ¶52.2.3).
[564] *Ibid.*
[565] See generally, Bittker & Lokken at ¶52.7.3.

adjusted taxable income percentage limit, and)in the case of the Bush Proposal[566]) adding a new interest disallowance rule that would apply in circumstances where the U.S. subsidiaries of a foreign parent are more highly leveraged than the overall worldwide group. In addition, carryovers would be curtailed.[567] "[568]

Additional Specific Cross-border legislation

In addition to the specific provisions aimed at restricting the amount of interest deduction on certain instruments similar to the above-mentioned provisions, there are also other provisions that are targeted at restricting domestic law and tax treaty benefits only to those persons who are with in the group of intended beneficiaries. These provisions are aimed at certain multiparty arrangements making use of intermediaries and certain types of hybrid entities. Although not directly aimed at HFIs, they have an important effect as they act to restrict the availability of tax benefits sought, including ITA. With respect to ITA, it can be argued that these provisions basically limit the availability of ITA only to those transactions that lack (or have a limited measure of) artificiality. As such, it does not act to limit the ITA but rather the artificiality.

Anti-conduit regulations[569]

Following the addition of §7701(l) to the Code in 1993, the Treasury was given the authority to issue regulations dealing with various multi-party or "conduit" financing arrangements[570] to recharacterize these transactions as transactions among directly two or more of the parties if necessary to do so to prevent the avoidance of US taxation.[571] The proposed regulations were issued in 1994 but were relatively limited in their application as they were issued under §881 and were in effect confined to withholding taxes. Moreover, as Bitkker & Lokken note, despite the wide authority granted by the Conference Report in 1993, the regulations adopted a relatively narrow definition of a "financing arrangement" not including within its scope guarantees and equity investments. The latter issue was partly dealt with in the final regulations issued in 1995, which includes in its definition of "financing arrangement" equity

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566 Provisions included in the Bush Administration's Fiscal Year 2004 Revenue Proposals.
567 Under the law prior to the change, the taxpayer was able to carryover the amount of disallowed interest to be used in future years, subject to earning stripping limitations.
568 New York State Bar Association, (2003).
569 See generally, Bitkker & Lokken at ¶15.03[6]. For an overview of the operation of these regulations, see Yu and Lisecki (2002).
570 One example for these types of transaction is the use of back-to-back loans with an intermidiary to obtain access to the benefits of a certain favorable tax treaty.
571 ABA Section of Taxation (2001) at p.2-3. According to Ring (2004), §7701(l) represents a codification of the general import of the decision of the Tax Court in *Aiken Indusries v. Commissioner* and later Revenue Rulings that followed.

investments, which have debt-like features. On the other hand, the final regulations include 75 exceptions whereas the proposed regulations only had sixteen.

§894(c) and regulations[572]

In 1997 temporary regulations were issued dealing with the availability of treaty benefits with respect to US source fixed determined annual, or periodic payments (FDAPI). The rationale behind these regulations was to limit the availability treaty benefits from foreign persons using US LLCs.[573] This move was strengthened by the addition of §894(c) which also grants regulatory authority to issue regulations to deny or limit treaty based withholding tax rates and other treaty benefits with respect payments made to or that are attributed to entities are treated as partnerships or other transparent entities.

To complete the legislative work, in 2002 final regulations were issued to deal with payments made by Domestic Reverse Hybrids (DRH).[574] [575] An important limitation is the related party limitation which generally requires the US person paying the dividend to be related to the DRH at the time of the payment and for the DRH to be related to a foreign interest holder at the time the DRH makes a deductible payment for US tax purposes to that foreign interest holder.[576]

Basically, like the above-mentioned anti-conduit regulations, §894(c) and the regulations that were issued in accordance with its authority are designed to provide a back-stop to the existing treaty residency and limitation-on-benefits rules by limiting the benefits of the US tax treaties network to entities that were intended to benefit from such network.

Outbound Financing

Foreign Tax Credit

Under §901, a US domestic taxpayer is entitled to claim foreign tax credit with respect to foreign tax it paid on its income, subject to the limitations imposed by §904(a) and §904(d). The former limitation is designed to prevent US persons from claiming foreign tax credit that would reduce their overall tax burden below the amount they would have paid if the only tax imposed on their income is US tax (the general limitation). The latter is meant to reduce the

[572] See generally, Bitkker & Lokken ¶15.03[7]. Yu and Lisecki (2002) and Maiorano Treadway & Zive (2003).
[573] These regulations were eventually finalized in 2000 (T.D 8889).
[574] A US entity (usually an LLC) that is classified as a pass-through entity (a partnership or a branch) for US tax purposes and as a separate taxable entity for foreign tax purposes.
[575] US Treasury Reg.§1.894-1(d)(1) issued under the authority of both §894(c) and §7701(l).
[576] Yu and Lisecki (2000) at 946.

taxpayers' ability to cross-credit different types of income by dividing the credit calculation according to separate baskets. However, as Blessing points out, these limitations are essentially a political compromise which is meant to limit taxpayers' ability to cross-credit and do not prohibit taxpayers from doing so as long as they keep within the four corners of the law.[577]

In addition, §902 allows the taxpayer, if it is a domestic corporation to claim an indirect foreign tax credit also with respect to foreign taxes paid by another corporation. Under §902, a US domestic corporation is deemed to have paid the taxes that are paid by a foreign corporation with respect to dividends distributed by that corporation to the US corporate taxpayer who is a shareholder of the foreign corporation.[578] These taxes, which are deemed paid by the US taxpayer under §902, are then credited under §901 subject to the limitation imposed on foreign tax credit by §904(a).

To qualify for the indirect credit under §902 the taxpayer must meet both the ownership test and the dividend test, which basically require the taxpayer to hold at least 10% of the voting stock of the foreign corporation and do so on the date the dividend is received.[579]

According to the regulations, "dividend" for the purposes of §902 has its usual meaning for US Federal tax purposes under §316.[580] Thus, in effect, as long as the payment comes within the definition of §316, it will be regarded as a dividend for the indirect foreign tax credit, even if the payment is classified under foreign law as not being a dividend. This approach is consistent with the view that unless provided otherwise, US Federal tax rules are supreme both in the international dimension and vis-à-vis applicable state laws.[581] The rationale underlying this approach is based, among other considerations, on the need to ensure that US foreign tax credit is not granted with respect to tax on income which is US source income. Thus, the determination of the nature of the income and its amount is done by applying US tax principles.[582]

In *Notice 98-5*,[583] the IRS has announced its position with respect to what it referred to as an abuse of the foreign tax credit system. In this notice, the IRS focused on two types of

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577 Blessing (2002) at 1059.
578 Where the foreign corporation is a CFC, §960 might apply with respect to distributions under Subpart F. See generally, Bitkker & Lokken 72.9.1.
579 See generally, Bitkker & Lokken at 72.9.2.
580 US Treasury Reg. §1.902-1(a)(11).
581 For an analysis of the relations in the international dimension see generally, West (1996). For an analysis of the relations between the Federal income tax law and state law with respect to the definition of a dividend, see Bitkker & Lokken at 92.1.2.
582 See generally West (1996).
583 1998-3 I.R.B 49.

transactions. First, transactions that are essentially a purchase of income streams that are subject to foreign withholding tax with the intention of using these foreign withholding taxes to maximize the taxpayer's US foreign tax credit position and thus reduce its US taxes. Second, ITA transactions in which according to the IRS, the taxpayer is exploiting the inconsistencies between the foreign tax system and the US system and enjoys duplicated benefits, once in the foreign jurisdiction and once in the US. According to the IRS, in the US the taxpayer is receiving foreign tax credit benefits by abusing the system.

The approach taken in the notice is to define abuse by reference to whether the expected economic profit from the transaction that gives rise to the foreign tax credit is not substantial in comparison with the claimed credit.[584] In applying this test, the foreign tax paid is regarded as a cost.

Example 4 in the notice illustrates the Service's view of what is an abusive use of a HFI. In that example, a US company incorporates a foreign subsidiary that purchases a preferred stock. The preferred stock is expected to pay an annual dividend. The purchase is financed mainly through an advance from a foreign investor residing in the foreign jurisdiction of the foreign subsidiary. The remaining sum is from a capital contribution made by the US parent to its foreign subsidiary. The advance from the foreign investor is a hybrid, characterized as debt for US tax purposes and as equity for the foreign jurisdiction tax purposes.

The inconsistent character of the foreign investor's interest in the foreign corporation results in an increase of the US taxpayer's share in the corporation (when examined from a US perspective) and as a result an increase in the US taxpayer's credit entitlement which is regarded as an abuse by the Service. It is interesting to note that the Service did not seek to reclassify the foreign investor investment based on foreign tax law principles.[585]

Notice 98-5 refers to regulations to be issued. Connors & Woll argue that authority for such regulations is doubtful. They reason this view by arguing that Congress has already severely limited the ability of taxpayers to use foreign tax credit by enacting the baskets limitations in §904(d), limiting the taxpayers' ability to cross-credit different items. They add that such regulations may also be inequitable if they do not provide for a safe harbor or exception for transactions undertaken for non-tax reasons. Lastly they refer to the decision of the Court of

[584] *Ibid.* Blessing (2002) p. 1064; Bittker & Lokken ¶72.5.3.
[585] Doing so would to depart from existing principle of US tax law whereby US tax law is applied to determine the tax liability (see generally West (1996)). In addition, it might also introduce new complexities in the application of the law including the risk that foreign tax credit might be given also with respect to US source income.

Appeals in *IES Industries v. Commissioner*[586] as an authority for questioning the rationale behind Notice 98-5[587]

[586] 253 F.3d 350 (8th Circuit 2001) rev'g 84 AFTR 2d 6445 (N.D Iowa 1999).
[587] Connors & Woll (2002) at 206-207.

Summary

There are five points that I tried to establish in this case study. First, that the treatment of HFIs depends on the distinction between debt and equity, a distinction that has lost its rationale in light of the modern day use of HFIs and is maintained, to a large extent, by drawing an arbitrary line between instruments that come within the definition of debt and those that come within the definition of equity. Second, although the distinction in the tax treatment of debt and equity is common to many countries, the application of the distinction in practice differs from one country to another and results in differences in the location of the exact distinction. When I examined the two countries that are the subject of this work, I tried to establish that the difference in location of the distinction is due to the combination of a different approach that is taken with respect to the taxation of financial instruments in general (economic substance v. legal form or legal substance) and years of reaction to domestic attempts to challenge the distinction in a domestic setting.

Third, HFIs by their nature are located on the distinction between debt and equity. This results in their common use for tax planning in a domestic setting, attempting to achieve a better treatment vis-à-vis more conventional instruments like debt or equity. The difference in approach between the tax systems coupled with the development of international capital markets, allow taxpayers to use HFIs also in an international setting in an attempt to enjoy the inconsistencies in treatment to their advantage.

Fourth, despite the development in financial markets and the increase in cross-border investments, tax systems, as evidenced in the case of HFIs, subject to cooperation in the relief of double taxation and exchange of information, still operate individually and without any reference to the treatment of the taxpayer in another jurisdictions. There are several limitations on the availability of ITA in HFIs.

Fifth, the simultaneous challenge both at the domestic level and at the international level creates a link and a tension between the two levels. Any change in the classification of instruments or payments at one level affects the treatment at the other level, requiring countries to take into account both domestic and international consequences of their approach.

At the practical current law level, we have to examine two simultaneous events – the interest deduction resulting from the debt classification on the one hand and the availability of the indirect foreign tax credit resulting from the equity classification on the other hand.

Looking at the instrument from the issuer's perspective, the question is whether the interest deduction granted to the issuer as a result of the debt classification in the issuer's own jurisdiction is dependant upon its tax treatment in the other jurisdiction. Similarly we should examine whether and to what extent the availability of the indirect foreign tax credit given to the holder with respect to the payment received on the instrument is dependant on its characterization in the other jurisdiction at the hands of the issuer.

In the absence of explicit premise that reliance should exist, it is necessary to determine whether or not an implicit premise exists in a way that the availability of either benefit is dependant on the treatment in the other jurisdiction. According to West, there are two possible outcomes to this question. First, if we take the view that benefits granted by the literal language of the legislation can only be revoked or denied by a condition or provision that is specifically stated in the legislation, then absent such limitation, the benefit should not be denied, even if the result is at odds with the purposes of the statute and regulations.[588]

On the other hand, application of a more purposive interpretation would lead us to deny the benefit granted by the legislation if the result of applying the statute or regulations is at odds with the underlying purposes of the legislation, even if such result is achieved by literal application of the statute and regulations.[589]

The approach adopted by West is a halfway approach according to which the literal interpretation of the legislation should be followed "*unless the result is so clearly at odds with the law's purposes that it is reasonably certain that the transaction would have been explicitly carved out from the scope of the law had it been considered by the legislators.*"[590]

In HFIs, in the absence of clear rationale for the distinction between debt and equity, the relevant consideration is where the jurisdiction in question decided to draw the line between debt and equity. Thus, prima facie, the first step is to apply the technical rules to determine the nature of the instrument and if the instrument is debt, the first step is followed by a second step which requires us to examine the existing legislation to determine whether the payment retains into interest treatment or not. In both the US and the UK, the legislation does not require any reference to be made to foreign law or to the tax treatment of the recipient.

[588] West (1996) at 183.
[589] West (1996) at 183.
[590] West (1996) at 184.

In analyzing the interest deductions in the US, West reaches the conclusion that interest deductions cannot be denied only on the basis that the income was not taxed at the hands of the foreign recipient.[591] Thus, it can be argued that if the instrument is regarded as a debt instrument and the income paid on it is not otherwise disallowed (for example, earning stripping rules), then the interest payment should be allowed in deduction.

The recent Supreme Court Decision in *Gitlitz*[592] should further support this view that in the absence of a clear provision in statute or regulations, the deduction should be allowed, especially since there are certain measures that are meant to either recharacterize certain types of instruments (in which case, the payment is not likely to be regarded as interest payment) or to disallow the deduction in the relevant year.

In the UK, in general, to be eligible for the interest deduction it is not sufficient for the issuer to establish that the instrument is classified as debt and that the income is classified as interest but also that none of the provisions denying the deduction of the interest is applicable in that case. In other words, if the instrument is classified as debt, then the payment is *prima facie* deductible interest payment unless there is a specific provision in the legislation that provides otherwise.

The important point is that in all the steps that are followed to determine the taxation of the payment, no reliance is made to foreign law or to the treatment of the instrument or the income under foreign law or to whether or not the other party is being taxed. Like in the US, there are certain rules that only become applicable if the payment is not subject to UK tax. However, once applied, they do not refer to or rely upon the possible classification or treatment in another country of either the instrument or the income paid on it.[593]

West's approach is also relevant with respect to the indirect foreign tax credit. Generally, if we consider the purpose behind the legislation, the indirect foreign tax credit rules are meant to reduce the multiple tax burden that is imposed on corporations at the international level by providing for a mechanism that would alleviate the third level of taxation in cross-border transactions, thus applying in cross-border transactions the same concept that is applied in domestic law by the dividend received deduction or the dividend exclusion rules.

[591] West (1996) at 184.
[592] *Gitlitz v. C.I.R.* 531 U.S. 206 (2001).
[593] In 1992, the use of equity notes resulted in legislation that used criteria that was "imported" from another jurisdiction but did not require the treatment in the UK to be determined in reliance with the treatment in another jurisdiction.

In the UK, the underlying foreign tax credit is granted in accordance with the relevant provision in the applicable tax treaty (even in the absence of a tax treaty, the provision is applied as if there was a treaty). In general, in the application of a treaty with respect to the underlying foreign tax credit, the definition of a dividend that is used is the UK definition (and not the definition of the country of source). This general rule does not apply if the treaty includes a specific definition that would apply (specifically) also for the purpose of the underlying foreign tax credit or if there is a specific limitation in the treaty that prevents the UK underlying foreign tax credit from applying.[594]

In the US, domestic law defines dividend in §316 and this definition is referred to in application of the indirect foreign tax credit provisions under §902.[595]

Thus, in both countries, despite the underlying rationale behind the indirect foreign tax credit rules, the definition referred to in the application of these rules is the definition under domestic law and there is no reliance or reference to the definition in the country of source.

[594] See, for example, 2001 US-UK tax treaty, Art. 24(4)(c).
[595] US Treasury Reg.§1.902-1(a)(11).

Chapter 7 - Cross-border leasing

Background

A lease is one of several finance options available for taxpayers. Unlike most other financing options like equity investment and debt investment, leasing provides a method for taxpayers to use the value of their business assets and the expected revenues from these assets in the future as a financing tool to assist them in the acquisition of these assets.

Outside the tax context, a lease can be defined as "*a contract essentially stipulating the separation of ownership of an asset and the right to use it;*"[596] In the legal and tax context, a lease has to be distinguished in its definition and scope from other similar types of transactions.

In the tax context, it is necessary to determine who is the owner of the asset for tax purposes because such ownership usually allows taxpayers to enjoy the benefits of depreciation deductions with respect to the asset. In addition, many jurisdictions provide generous depreciation deductions that exceed commercial depreciation as a method for encouraging taxpayers to invest and to acquire new assets to be used as part of their business. It is thus necessary to ensure that the benefit provided is received by those who were intended to receive it in the first place.

Originally, leasing was treated as a rental transaction. This resulted in the lessor being treated as the tax owner of the asset and the person entitled to enjoy the depreciation benefits.[597] Such lessor was thus able to enjoy the generous depreciations deductions both to defer and to shelter income he had from other sources. The solution was to transfer the ownership to the lessee thus denying the lessor the ability to use the depreciation deductions. In practice, different countries followed different methods to achieve this goal of limiting the benefits of depreciation deductions only to those who were intended to be covered by it.

Traditionally, a distinction has been drawn between two types of leases, financial lease and operating lease.

In broad terms, a finance lease involves a lease in which the lessor passes most of the economic attributes of ownership to the lessee, even though the lessor retains the legal title

[596] Gao (1999) at 17.
[597] See generally below in the discussion of the UK tax treatment of leasing transactions and in Tiley (2003).

to the asset. This type of transaction resembles a secured finance whereby the lessee is the owner of the asset which is secured to the lessor who provides the finance.

An operating lease represents the complete opposite. Under an operating lease, the lessor retains most of the attributes of economic ownership and the lessee is awarded mainly with the right to use the asset for a period that is shorter than the useful life of the asset. At the end of the period, the asset returns to the lessor. This type of transaction resembles a simple rental transaction.

Not all countries follow this distinction. In 1990, the International Fiscal Association discussed cross-border leasing. In the introduction to the topic, the General Reporter identified three main approaches taken by countries in the treatment of lease transactions. The first approach is the legalistic approach where the legal owner is regarded as the owner of the asset for tax purpose. An alternative approach is the economic substance approach whereby the economic owner of the asset as the tax owner of the asset (similar to the above-mentioned distinction).[598] In addition, a third method has developed, a middle position between the economic approach and the legal approach.[599]

During the discussions, it appeared that the different delegates were unable to agree on a common uniform definition for finance lease and operation lease and on a common approach to the taxation of leasing transactions.

Thus, in an attempt to limit the availability of accelerated depreciation deductions only to those transactions and taxpayers who were intended to be covered by the legislation, each tax system followed a different approach leading to the creation of a disparity among the different systems, a disparity that allows taxpayers to simultaneously enjoy the benefits of accelerated depreciation deductions in two tax systems by structuring the transaction in a way that satisfies the requirements of each system. To illustrate this, in the following case study, I focus on the different approaches taken by the US and the UK both domestically and with respect to cross-border leasing transactions where special measures were adopted to limit the availability of these depreciation benefits.

[598] The mere fact, however, that two countries follow the same approach does not mean that they adopt the same rule for distinguishing between different transactions. For example, it has been possible for a long time to arrange a transaction in a way that on one hand the period of the lease would not exceed 80-85% of the usual life of the property and on the other hand would be long enough to constitute at least 90% of the depreciable life of the property for German tax purposes. In that way, both the US lessor and the German lessee would qualify as tax owners of the property, each in his own country (see also Cozart).

[599] Lindencrona & Tolstoy (1990) at 30.

Reasons for entering into a leasing transactions

There are many reasons for entering into leasing transactions, some are tax reasons and some are non-tax reasons. Overall, leasing transactions are not a new type of finance and it dates back to the 19th century and even before.[600] One commentator even went back to around 2010 BC.[601]

Modern leasing, however, goes back to 1956 in the US[602] and more widely to the 1960s when the first leasing companies were established in the industrial countries.[603] In theory, the main difference between leasing and other financing alternatives is that in leasing it is the leased equipment which is borrowed, instead of the funds.[604]

Taxation is an important element in the evaluation of which finance option to be used in a given situation.

Leasing is essentially a financing transaction. Ideally, efficiency and tax neutrality require that tax should not be a consideration in the determination which method of finance should be used. For example, finance lease and secured loan should receive the same tax treatment. Similarly, operating lease and rent should be treated the same.

However, the benefit of accelerated depreciation granted to the owner of leased property together with the different approaches taken by different countries with respect to the characterization and treatment of leases and ability to transfer the attributes of ownership under a lease, all create distortions that allow leasing to be more beneficial that similar methods of finance. For example, secured loan and finance leasing should be treated similarly. In some occasions, however, leasing proves to be much more beneficial.

One example is of a loss corporation that wishes to invest in new equipment. The corporation cannot use the benefit of the depreciation deductions because of its losses. If the finance lease, unlike a secured loan, treats the lessor as the owner of the property, the lessor is able to use the benefit of the depreciation deductions and pass the benefit (or part of it) to the lessee (who is unable to use the benefit at all) by way of lower fee or lower interest payments on the lease. As a result, despite the economic similarity, there is a clear after-tax

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600 Park (1981) at 107.
601 Nevitt & Fabozzi at 21.
602 *Ibid.*
603 Lindencrona & Tolstoy (1990) at 22.
604 *Ibid.*

distinction between the two methods of finance.[605]

Since, however, different countries approach the taxation of leasing differently, differences result not only domestically between leasing and similar financing transactions but also internationally between treatment of similar leasing transactions.

Outside the tax context, leasing has several advantages over other methods of finance. First, it allows the borrower, the lessee, to raise more funds with respect to the same equipment. While it is usually uncommon for banks and other financial institutions to loan funds that represent 100% of the secured property, in leasing the lessee is receiving finance in an amount that equals the cost of the leased equipment. As a result, the lessee's cash flow position is improved vis-à-vis a conventional debt financing.[606] Second, whereas regular borrowings appear on the borrower's balance sheet as liability thus increasing its leverage, leasing is not treated as a liability. Moreover, leasing can more easily adapt to balance sheet considerations.[607] Third, it is possible that from a commercial law perspective, lenders would prefer using leasing instead of traditional loans to ensure better standing in case of bankruptcy of the lessee. Since ownership in a true lease is usually vested in the lessor, it may better protect the provider of the funds (the lessor in a two party lease and the third party lender in a three-party leveraged lease) in case of default or bankruptcy of the lessee.[608] Fourth, leasing is a flexible instrument that can be adapted and "tailor made" to match the specific needs of the specific customer.[609]

Especially in a time where the need for finance is high and companies seek to minimize their finance cost, leasing becomes more popular due to some of its non-tax advantages and the fact that it allows companies to raise more money with the use of similar property.[610] Naturally, tax advantages can prove very helpful as well.

Sigao provides a list of more than ten advantages for leasing to a lessee (over other alternatives for finance). Out of these advantages, only one is tax oriented. The rest of these advantages include, among others, certainty, sound hedge against inflation, avoidance of share ownership, avoidance of loan covenants or capital investment restraints, provision of

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605 In the UK, the Inland Revenue has announced its desire to change the leasing rules and treat finance leases and a selected number of operating leases as transferring the ownership to the lessee making him the taxpayer entitled to depreciation deductions. See generally Inland Revenue (2003).
606 Cozart at 9.
607 Lindencrona & Tolstoy (1990) at 22.
608 Park (1981-2) at 112.
609 Lindencrona & Tolstoy (1990) at p.22.
610 Fabozzi, *ibid.*

constant cost financing, allowance of more flexible cash budgeting, etc.[611]

At the same time, tax has always been an important motivation.
"One of the principal attractions of leasing as a source of finance derives from the finance lessor's ability to take advantage of tax depreciation which cannot be utilized immediately by the user, while the user is still able to enjoy many of the risks and rewards of economic ownership."[612]

A good example to such a situation is given by Clayson,

"But what if the user does not have the 'tax capacity' to use these allowances? If it is investing heavily at the beginning of its trading life, profits may be thin or non-existent. Alternatively, it may have surplus advance corporation tax available to set off against the mainstream liability of future years (although following the abolition of ACT in April 1999, surpluses no longer continue to accumulate) so that the reduction of taxable profits by virtue of available capital allowances would be of limited value. In these circumstances it might well be attractive to acquire the equipment under a lease which permits the lessor to take the allowances: the tax benefit could then be shared between the lessor and the lessee via the rentals due under the lease. In this way, the lessee may be able to finance its investment in the equipment at a smaller effective cost of funds than the interest rate applicable to a loan."[613]

To summarize, in addition to possible non-tax advantages, leasing provides two main tax advantages:

First, the ability for taxpayers to transfer tax attributes from one taxpayer who cannot use them to another who can. Second, a tax deferral by granting accelerated depreciation that allows the taxpayer entitled to them to defer his tax liability as described in the above-mentioned quote. These benefits led legislators and tax authorities to adopt measures designed to limit the availability of depreciation deductions to those taxpayers and transactions that were originally intended to benefit from the leasing rules.[614]

Nonetheless, one should not conclude from the above quote that leasing is mainly a tax-

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[611] Gao (1999) at 20.
[612] PriceWaterhouseCoopers (2002) at 182.
[613] Clayson (2002) at 11-2.
[614] For example, §469 to the Internal Revenue Code preventing enjoyment in such transactions from high income individuals who would otherwise try to utilize passive losses to offset their high active income.

motivated transaction. Supporting this view are the non-tax advantages of leasing as well as the actual figures of leasing transaction. In the UK, for example, of the £23.6 billion of new business made by Finance Leasing Association (FLA) members in 2001, 45% related to hire purchase and other non-tax based leasing.[615]

Thus, it would be wrong to conclude that leasing transactions are entirely tax based.

"Another interesting aspect of cross-border leasing is that despite changes in the tax legislation in the UK and the US around 1986, reducing tax rates for individuals and corporations and widening the tax base, the volume of national leases has not been reduced. This seems to indicate that leases are not entirely tax based but rather another tool for equipment financing. However, it is also reported e.g. from Hong Kong and the UK that specific changes in tax legislation made with the purpose to reduce the tax benefits of outbound cross-border leases have had a negative impact on the volume of such leasing activities. The reduced corporate tax rates in the US and in the UK seem to have had a negative impact on leverage leasing a type of leasing where at least three parties are involved, a lessee, a lessor and a long term creditor."[616]

Benefits of international leasing

With the relaxation of exchange controls in many countries, cross-border or international leasing became more acceptable and popular. It allowed a larger number of companies to seek finance options elsewhere, usually at a reduced cost. In addition, it allowed leasing companies to diversify their leasing portfolio and thus reduce some of the non-tax risks associated. At the same time, a lessee who is interested in obtaining a certain asset through leasing is no longer limited to local lessors. As a result, the competition increases and the ability of lessors to provide lease on better terms may cause a lessee to prefer one lessor to another. There are many reasons that are relevant in the choice of a lessor or a lessee and arguably tax is only one of several reasons. It is, however, an important reason, as it may allow the lessor to pass some of the benefits to the lessee in the form of better lease terms and thus become more competitive.

In that sense, the international nature of cross-border leasing allows both lessors and lessees to take advantages of the different tax principles in the different countries regarding both the classification of the transaction and the timing of the lease payments ("double-dip" and

615 PriceWaterhouseCoopers (2002) at 3.
616 Lindencrona & Tolstoy (1990) at 23.

defeasance leases, respectively, both described below), to structure leases in a way that is very beneficial to them and as a result to be able to reduce some of the finance cost, by offering, for example, similar leases but with lower costs.

While the place in which the equipment is going to be used is relatively fixed, other elements in the transaction are usually more flexible and can change in accordance with changes in the legal, accounting and tax environment. In an industry that is highly competitive, even minor changes may have an impact on the way things work.

Two key questions have to be examined. First, is the transaction in question a leasing transaction (as opposed to a secured finance transaction, for example)? Second, who should be the one enjoying the benefit of the depreciation deductions?

Depreciation deductions are basically the equivalent of expenses in the acquisition of a capital asset. In most cases, expenses, which are allowed against ordinary income, are not allowed in deduction with respect to a capital asset. To compensate for that and to encourage taxpayers to acquire business assets, depreciation deductions were introduced with respect to certain types of assets to reduce the disadvantage of acquiring an asset (as opposed to renting it). Thus, the depreciation deductions estimate the overall life of the asset and allow the taxpayer who acquires the asset to deduct a ratable portion of the price of the asset in every year during the life of the asset. Several countries, however, did not stop at this and made the depreciation deductions more generous than a simple economic or ratable depreciation (by allowing accelerated depreciation). As a result, depreciation deductions can be more advantageous than merely rent deductions as they allow the taxpayer the benefit of deferral by advancing deductions and deferring the payment of tax.[617]

In that sense, the depreciation deductions should be seen as a type of incentive granted to the owner of the asset. Being in the form of a benefit or an incentive, it is meant to encourage a certain activity by a certain group of taxpayers. Thus, one can assume that where the fisc does not agree with the use of the benefits by the taxpayer (for example, if the taxpayer decided to transfer the benefits in a way that does not coincide with the aim of the legislation i.e. to someone who was not intended to benefit) then it would disallow such use. The

[617] Tiley mentions two main policy reasons behind the grant of depreciation deductions. The first one is to encourage activity and the second one is to provide compensation for the use of the property and depreciation in value. Over time, legislation tends to be influenced by one of these two reasons. When the first reason controls, generous accelerated depreciation deductions are usually available. For example, during a period of slowing economy or recession, hoping the depreciation allowances would encourage businesses to invest more. on other times, the second reason might control, limiting the extent of depreciations deductions and their timing to be more parallel with economic depreciation of the property. See generally, Tiley (2003).

general acceptance of leasing suggests that transfer of benefits is allowed. This acceptance is, however, subject to limitations in certain cases, for example, in the case of "export leasing."

In a typical leasing transaction, a lessor is entitled to the depreciation benefits as he is regarded as the owner of the asset even though he is not using the asset. Allowing the lessor to claim depreciation deductions seems to be warranted as long as the rationale behind the depreciation deductions is not frustrated.

In some cases, protection of the fisc against revenue loss is also an important policy in the design of tax legislation. For example, as it was mentioned, many countries have adopted special rules to prevent so-called "export leasing". One of the main rationales for such legislation is that while the fisc is happy to allow transfer of benefits within its boundaries from one taxpayer to another and thus to encourage certain activities (even if it is at cost to the fisc), the fisc is usually unwilling to "sponsor" or finance foreign taxpayers by allowing depreciation deductions (sometimes accelerated depreciation deductions) to be taken against domestic income thus reducing domestic tax liability (of the lessor) while the asset with respect to which these deductions are taken is not used by a domestic taxpayer and not used in the country.[618]

Defeasance leases[619] have been quite popular and led to many legislative responses over the years. Without going too much into this type of lease, it appears that the rationale was not to allow taxpayers to claim depreciation deductions in situations where the grant of these deductions would frustrate the rationale and intention of the legislation. Similarly, many jurisdictions adopted certain provisions to curtail and reduce (if not eliminate) the extent to which lessors are able to use tax depreciation (or their equivalent) when the equipment is used outside the lessor's country of residence.[620]

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[618] See Hariton (1999).

[619] The general reporters for the 1990 IFA Congress define defeasance in the following way "*A defeasance in the context of leasing is an assumption by a finance institution of liability for the payment of leasing fees. A defeasance which is non-recourse to the lessee is called a legal defeasance, and a defeasance with recourse to the lessee is called an economic defeasance.*" (Lindencrona & Tolstoy (1990) at 32).

[620] For example – ss 109 and 110 of CAA 2001. See our discussion below (pp. 197-203).

The Double-dip

In the context of international leasing transactions, a double-dip is a description of a situation whereby one leasing transaction gives rise to two simultaneous depreciation deductions, one in the hands of the lessor and one in the hands of the lessee.

"A double-dip transaction relies on and exploits the differences between two dissimilar legal systems and, in order for this "tax law arbitrage" to be successful, it is essential that the systems be truly and substantially distinct."[621]

In general, tax systems attribute certain advantages to owners of property. The most important of these advantages is the ability to claim depreciation deductions with respect to the property.

"The key tax benefit exploited in a tax-oriented lease transaction – as practiced in the U.S. and around the world – is that attributable to depreciation deductions or other tax allowances for the cost of the leased property. Leasing, as detailed in chapter 5, is a technique for transferring all or a portion of the benefit of such deductions from a taxpayer to a person who cannot use the deductions directly."[622]

Like leasing, this type of transactions is not a new phenomenon. In a 1981 article dealing with international leasing[623] Park describes a transaction between a US party and a UK party whereby both parties are regarded, by their domestic tax legislation as the tax owner of the property. This result is based on the different approach taken by the UK and the US with respect to characterization and taxation of leasing transactions.[624]

The added benefit of double-dip leasing is not in the availability of a second set of deductions. This second set is already available under regular single-dip leasing which gives rise to two sets of deductions, one at the hands of the lessor (depreciation) and one at the hand of the lessee (rent). The difference is in the timing of the second set of deductions, which as a result of the inconsistent characterization of the transaction becomes accelerated (like the first set) and allows both taxpayers to take a deduction ahead of the actual timing of the expenditure.[625] In effect, the parties share this additional benefit between them. Often,

[621] Shrank & Gough (2003) §25:3.2 (p.25-139).
[622] Shrank & Gough (2003) at 25-7.
[623] Park (1981-82).
[624] A legal formalistic approach and an economic approach, respectively. See generally, Park (1981-82) at 148.
[625] Ring (2003).

this benefit is evident in lower fee charges by the lessor or lower implicit interest payments in the rent paid by the lessee to the lessor.

One of the major limitations that is imposed, albeit indirectly, on the availability of the double-dip leasing is the special rules against export leasing, rules that are intended to discourage the use of export leasing transactions by restricting the benefit of the single-dip. In general, these rules, which are discussed more in detail below,[626] spread the depreciation on the property over a longer period making the leasing a less attractive finance option. In the context of double-dip leasing, it would not be beneficial for a lessor to engage in a transaction that is subject to the export leasing rules because the application of these rules would have the result of neutralizing the benefit achieved through the double-dip. For that reason, double-dip leasing only exists where it is possible for the parties to achieve regular depreciation rate for the lessor, either because no export leasing rules exist or because the transaction qualifies into one of the exceptions in these rules. In other jurisdiction, for example the UK, double-dip leasing is usually not pursued as outbound transactions.

Therefore, for a double-dip leasing to be beneficial, it has to be a transaction of the type that is not objected to by the tax laws in the country of the lessor either directly (because the transaction fits into one of the exceptions of the export leasing provisions) or indirectly (because there are no general restrictions on export leasing), making the transfer of tax attributes to the foreign lessee acceptable.

However, if a transaction is to be tax effective as a double-dip transaction in the first place, it is necessary for both the lessor and the lessee to be regarded as the tax owner of the leased property (or as the person entitled to claim the depreciation deductions), each in his own country and for each of them to be able to claim deprecation deductions in his or her country of residence. One method of achieving this result is for the transaction to be regarded as a sale from the lessee's country perspective and as a lease from the lessor's country perspective. Another method is for it to be regarded as a secured loan (sale and a loan) from the lessee's country perspective and as a lease from the lessor's country perspective.

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626 See pp. 197-203 below.

Possible structures of cross-border double-dip leasing transactions[627]

Outbound double-dip

There are several ways in which US lessors managed in the past to create successful cross-border double-dip leasing transactions. In all of these planning options the US lessor was also the manufacturer of the leased property. As a result, the transaction benefited from the application of the FSC or ETI legislations.

The simplest option was to enter into a one-tier lease whereby the transaction is regarded as a true lease for US tax purposes and as a hire purchase for foreign tax purposes. As a result, the lessor was regarded as the owner of the leased property for US tax purposes and was entitled to claim depreciation deductions. In addition, the foreign lessee was also entitled, due to the characterization of the transaction as a hire purchase, to claim depreciation deductions in the foreign jurisdiction.

The inconsistent treatment was obtained through the use of a purchase option. Several jurisdictions, usually those that had a strong UK influence, tended to characterize a transaction in which a purchase option is granted to the lessee as a hire purchase transaction, even if the purchase option was at or above the anticipated value at the end of the leasing period.[628] Under a hire purchase agreement, the hirer (lessee) was the party that was entitled to claim depreciation deductions. As a result, both lessee and lessor were able to enjoy depreciation deductions.[629]

Inbound double-dip

In the past, successful inbound double-dip transactions have two common features: these transactions were denominated and documented as a lease and the foreign lessor or a party acting on his behalf held the title to the leased asset.[630]

However, the most challenging obstacle in obtaining successful inbound double-dip leasing transactions is to establish that the US tax treatment of the leasing transaction should be based on the substance of the transaction as opposed to its form. For that purpose, following

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[627] See generally, Shrank & Gough (2003) Ch. 25.
[628] Another method of obtaining the inconsistency was through a lease to a lessee in a country has a statutory or regulatory rules regarding the maximum period allowed for a lease (e.g. Germany). Any transaction exceeding this maximum length would be treated as a conditional sale, making the lessee the owner of the leased asset for local tax law purposes.
[629] Shrank & Gough (2003) at 25-128.
[630] Shrank & Gough (2003) at 25-141.

the *Coleman* strong proof standard[631], the taxpayer has to establish that there is a strong proof supporting such characterization.

In the context of inbound cross-border leasing the *Coleman* strong proof standard is described as including two cumulative requirements. First, the taxpayer has to establish that he bears, vis-à-vis the foreign lessor, all of the significant burdens and benefits of ownership in the leased asset. Second, that the parties intend the US party (the lessee) to be the US tax owner of the asset to the exclusion of the foreign party.[632]

The basic alternative option was to create a lease with a fixed price purchase option at a nominal price or a lease with an automatic passage of title upon the satisfaction of a pre-determined event. These alternatives were not always available and they became less and less common with the development of advanced tax laws in the foreign jurisdictions to deal with the taxation of leasing transactions.

A successful planning option that was used in the past to achieve double-dip treatment was through the use of an economically compelled purchase option in the leasing transaction. This option has the effect of treating the US lessee as the owner of the leased property for US tax purposes (according to the burdens and benefits test) while not altering the status of the foreign lessor as the owner of the leased asset according to the tax laws in the foreign jurisdiction. Unlike the more basic alternative of a nominal fixed price purchase option, under this alternative, although the lessee has the option of buying the leased property for a substantial price,[633] there are also other factors that will compel the lessee to exercise the option at the end of the lease period.[634]

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[631] The rule which bears the name of the case in which it was decided requires a higher burden of proof from a taxpayer who argues a transaction should be treated according to its substance and while disregarding its conflicting form. See generally, *Coleman v. Commissioner*, 87 TC 178 (1986).

[632] Shrank & Gough (2003) at 25-142.

[633] The price of the option is important for the understanding and for the classification of the transaction. One way of distinguishing between a pure lease (operating lease) and a finance lease (similar to secured finance) is through the price of the option at the end of the lease period. In a pure lease, the payments that are made from the lessee to the lessor represent only the rental for the use of the property during the term of the lease. At the end of the lease period, the value of the leased property should equal its FMV and any option granted to the lessee to acquire the property at that time should be at least at FMV. In contrast, in a secured finance (financial lease) the lessee is normally paying not only for the rental of the property but also payments of principal to acquire equity in the property. Thus, at the end of the lease period, any option granted to the lessee to acquire the property would be lower than FMV and even significantly lower, taking into account the payments of principal made by the lessee during the term of the lease. As a result, it is also possible to ascertain the classification of transaction by reference to the value of the option given to the lessee (just for sake of completeness, it should be noted, though, that in some jurisdictions, the mere grant of an option would be sufficient to treat the transaction as a secured finance (finance lease) regardless of its value).

[634] Shrank & Gough (2003) at 25-158 – 25-160.

Another alternative that was used was a guaranteed cross put and call. According to this alternative, the lessor has an option to sell the leased property at the end of the leasing period at a substantial price and the lessee has an option to buy the leased property at the end of the leasing period and at the same price. The combination of these two options ensure that whether the price of the leased property increases or decreases, one of the options will be exercised with the effect of transferring the asset to the lessee, making the cross option the equivalent of a deep in the money option.[635]

Two-tier transactions

In a sense, the differences between the two tax systems and their classification of the transactions replaces the use of artificial steps in the transactions to create the desired beneficial result. Sometimes, however, the differences between the two tax systems are not sufficient to result in ITA. For that purpose, taxpayers would try to use an intermediary in a third country to achieve the desired inconsistency and the ITA. The challenge with these structures is to structure them in a way so they are not caught within the scope of tax avoidance.

Nonetheless, if and to the extent such transactions come within the scope of tax avoidance, this is due to the artificiality element and not to inconsistency in treatment in the two or more jurisdictions. For example, a two-tier transaction whereby the lessor leases the property to a lessee resident in country X that then subleases the property for a period just short of the head lease period to the intended lessee in country Y. to a large extent, the two leases, the head lease and the sublease are granted on similar terms. Such structures are usually more aggressive due to the artificiality portion (the existence of the intermediary and the result two leases granted back to back on similar terms). They are used when the laws of the jurisdiction in which the lessor resides and those in which the lessee resides (country Y) are different but not enough to support the creation of a one-tier double-dip lease.

A more sophisticated option was to enter into a lease/sublease structure. According to one variation of this option, a US lessor is entering into a twelve-year lease with a party who is able to use Australian tax benefits. The lease includes a purchase option and is regarded as a hire purchase agreement in Australia and the lessee is regarded as the owner of the leased property for Australian tax purposes. The lessee then enters into a sublease with a sublessee/user for a period of twelve years. The sublease does not contain an option to purchase the asset and is treated as a lease transaction.

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[635] Shrank & Gough (2003) at 25-160.

UK - Characterization and capital allowances

A central distinction in the leasing area is the distinction made by standard accounting practice and in particular SSAP 21 which distinguishes between finance lease and operating lease but does not determine whether a transaction is a lease for tax purpose. Nonetheless, this qualification is relevant to an increasing number of aspects relating the taxation of leasing in the UK, an area that becomes more and more affected by accounting principles.[636] It appears that following the introduction of certain changes in Finance Act 1997 and in Finance (No. 2) Act 1997, the lessor's accounting treatment will be paramount in the determination of the lease classification.[637]

SSAP 21 distinguishes between a finance lease and an operating lease. The latter is a lease whereby the lessor retains ownership over the leased asset by retaining substantially all the risks and rewards of ownership. A finance lease, on the other hand, is transaction whereby the lessee is vested with substantially all the risks and rewards of ownership and thus economically is the owner of the leased property. In essence, a finance lease is like a loan.

The test for the determination whether substantially all the risks and rewards of ownerships have passed from the lessor to the lessee is based on a comparison of the rental cash flow of the lease vis-à-vis the fair market value of the leased property.

This distinction, however, is irrelevant for the tax treatment of the transaction and in particular for the purpose of applying the capital allowances. For these purposes, the only relevant consideration is the identity of the legal owner of the asset. The test applied is a formal legal ownership test that rejects the economic substance over form approach taken by SSAP.

As it was commented by the Inland Revenue "*When SSAP 21 accounting treatment was introduced in 1984 the Government decided at that time not to follow the same 'substance-over-form' approach for tax purposes. The tax system continues to regard a finance lease as the hire of an asset and not as a loan.*

Lessor

[636] See also Inland Revenue (2003).
[637] PriceWaterhouseCoopers (2002) at 180.

The finance lessor, as the legal owner of the kit, continues to get the capital allowances and other reliefs for capital expenditure, such as the film reliefs.

Lessee

The finance lessee gets no capital allowances but continues to get relief for the gross rentals which, in total, equal the capital cost of the kit (the 'loan') and the 'interest' on the 'loan'."[638]

In general, a finance lease for accounting purposes is treated differently for tax purposes mainly due to the fact that the ownership of the leased equipment remains with the lessor. As such, the lessor is going to be charged on the rental income received from the lessee and allowed to deduct the capital allowances given with respect to the property.

If the lease is regarded as an operating lease, the tax treatment is going to be similar to the accounting treatment, mainly due to the similarity in the identity of the owner of the leased property, the lessor.

It is possible for a lease to be structured as a finance lease for accounting purposes and as a lease for tax purposes. In that way, despite the similarity to financial transactions (loans) the transaction is taxed as a leasing transaction, possibly a much favorable tax result.

Following the formalistic approach to the characterization of transactions for tax purposes, it is necessary to determine whether a given transaction should be classified as a lease or not. This is a question to be determined based on legal nature of the relationship between the parties to the transaction and should be the starting point in the analysis.[639]

These are several types of transactions that are similar or resemble one another. Since the ability to claim capital allowances is an important tax advantage of leasing, a thorough understanding of the differences between the different types is a crucial aspect in obtaining this benefit.

Once the transaction has been classified according to the legal form and the identity of the owner has been determined, the timing of the payments made under the transaction and their character are determined by applying SSAP 21. Thus, while accounting rules and the distinction between operating lease and finance lease control the determination of the timing

[638] Inland Revenue Finance Leasing Manual - FLM5.01.
[639] Shrank & Gough (2003) at 11-4.

and character of the payments made under the lease, they are irrelevant for the determination of the nature of the transaction itself. As a result, this hybrid method of classification basically applies finance lease accounting to a transaction that is classified as a regular lease i.e. the lessor has ownership of the property (as opposed to a finance lease where the ownership is considered to have passed to the lessee). This may result in complex issues relating to the application of SSAP 21, for example, in the characterization of the payments made under the lease.

The Key – Entitlement to claim capital allowances

An essential feature of a lease is that the lessor retains full ownership of the asset and only transfers a right to use the asset for a restricted period, at the end of which the asset is returned to the lessor. Thus, in the UK, the term "lease" is usually used to describe contracts that do not grant the lessee an option to acquire the property at the end of the lease term and thus allow the lessor to claim capital allowances. The existence of an option to purchase the property at the end of the lease period would usually result in classifying the transaction as a hire purchase and treating the lessee/hire purchaser as the owner of the property.[640]

A hire purchase, on the other hand, is a combination of a lease with an option to acquire the property at the end of the lease period, usually for a nominal sum.[641] While the existence of option at a price higher than nominal is relatively common in other jurisdictions, in the UK it is not used in order to avoid timing and character issues under SSAP 21.[642]

Nonetheless the UK approach is not to transfer ownership in the property until the option is exercised. That is, as long as the option is not exercised, ownership is still vested in the original owner.

The general rule is that capital allowances (the UK equivalent of depreciation deductions for tax purposes) are given to the "owner" of the property. Thus, CAA 2001 s 24 requires an ownership of the property as a condition for claiming the capital allowances. This requirement replaced the prior requirement under CAA 1990 that the property would belong to the taxpayer. This change, however, is considered to be stylistic and not substantive.[643]

[640] PriceWaterhouseCoopers (2001) at 202.
[641] Clayson (2002) at 11-4. Arguably, the existence of the purchase option itself would bring the transaction into a hire purchase classification for UK tax purposes. However, since a central feature of the planning is to be able to claim depreciation in both jurisdictions, it is necessary to ensure that the transaction does not run into capital/income issues as a result of the relatively high value of the option. According to Clayson, this issue can be solved by using either economic or legal defeasance to smooth the treatment on both sides of the transaction.
[642] See the preceding part.
[643] Tiley (2003) at 24A.2.2.

Under both, the taxpayer is required to establish that he has an absolute and beneficial ownership in the property and this is examined from a legal perspective (and not, for example, from an economic substance or accounting perspective).

Several important aspects of the capital allowance legislation were raised and discussed recently in the Court of Appeal in *Barclays Mercantile Business Finance Ltd. (BMBF) v. Mawson*[644] (hereinafter, "*Barclays*" or the *Barclays* case). Although the subject matter before the court was a sale-leaseback transaction, the court made some very important comments regarding the capital allowance legislation, its application and its rationale. The narrow issue at stake was whether the taxpayer was entitled to claim capital allowances with respect to the pipeline (which was the leased property). The decision, however, raised two wider issues that are required for the decision on the narrow issue. First, what is the purpose of capital allowances? Second, does the *Ramsay* principle apply with respect to sale-leaseback transactions as the one that took place in *Barclays*?

The facts of the case are quite complex. However, it is possible to briefly describe them in the following simplified way:[645] an Irish company, owner of a pipeline, entered into a sale-leaseback transaction with BMBF, a UK resident company, with respect to part of the pipeline. The leaseback was for 32 years. As part of the transaction, the Irish company was required to deposit the consideration received on the sale on a deposit that guaranteed the Irish company's payments on the lease (the deposit was structured in a way that every time a payment had to be made, the Irish company would be able to withdraw it from the deposit. The twist was in the fact that the deposit, going through a long chain of companies essentially went back to BMBF, although (and this is an important point) BMBF did not have the right to use it.

The Special Commissioners applied the *Ramsay* principle and found that the transaction, as it was conducted, lacked economic reality. Thus, they refused to allow BMBF to enjoy the capital allowances. [646] The decision was appealed and on appeal to the High Court, Park J adopted the Special Commissioners findings and decision and denied the capital allowances.[647]

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644 [2003] EWCA CIV 1560 (8); [2003] STC 66.
645 This description is based in part on Johnson's brief description of the facts in Johnson (2003).
646 Paragraph 14 of the CA decision. Cf. Nash & Gonen (2003) at 109 Their view was also shared by the Court of Appeal.
647 At para. 22. Park J applied the judicial anti-avoidance doctrine of *Ramsay* as it was articulated by the House of Lords in *MacNiven*, found that the term "incurring expenditure" is a legal term and as such has to have a legal meaning to it. Following Lord Hoffmann's judgment in *MacNiven*, he looked at the underlying purpose of Parliament in enacting the capital allowances legislation under the specific section in question which was not "to

The Court of Appeal disagreed with both the Special Commissioners and Park J, finding that the Special Commissioners finding (and Park J's affirmation of this finding) that there was no business reality was not based on any evidence or factual foundation and was actually contrary to the evidence given at the trial.

According to Gibson LJ, *"[T]he purpose of the capital allowances legislation would appear to be to encourage the expenditure of capital on plant and machinery. The fact that the trader incurring the expenditure would not himself use the plant or machinery but would lease it and pass on the benefit of the capital allowances to the lessee was not seen to be any reason for not conferring capital allowances on that trader who had incurred the expenditure. I can see nothing in the legislation which substantiates the judge's view that s 24 was enacted so that capital allowances could be used to provide lessees with finance at attractive rates to use and to develop their real business activity."*[648]

He then continues to reject the lower courts' focus on the origin of the funds.

"To the test posed in s 24 it is immaterial how the trader acquires the funds to incur the expenditure or what the vendor of the provided plant or machinery does with the consideration received. Provided that the expenditure is incurred on the provision of plant or machinery and is so incurred wholly and exclusively for the purposes of the trader's trade, subject to s 75(1) it is irrelevant to the operation of s 24(1) whether the trader's object is or includes obtaining capital allowances."[649]

Regarding the circularity argument according to which due to the circularity of the funds the taxpayer did not really incur the expenditure, Gibson LJ began by finding that,

"Lord Hoffmann in MacNiven (at p. 398 para. 68) said that for the purposes of some concepts in tax legislation the circularity of the cash flow and the fact that the transaction took place entirely for tax purposes would stamp the transaction as something different from that contemplated by the legislation. But he does not say that the circularity of the movement of the money would itself be enough. I do not accept that the circulation of money in the present case means that the transaction is to be treated like the scheme in Ensign."[650]

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enable capital allowances to be used so as to provide to the lessees attractive rates finance for them to use and to develop their real business activities" (para. 22 of the Court of Appeal decision).

[648] Para. 37.

[649] *Ibid.*

[650] *Ibid.*

Based on that and declining the application of the *Ramsay* principle, the court found that the taxpayer did incur the expenditure.

What can be learned from the decision? First, the court confirmed that the sharing of tax benefits that arises from the availability of capital allowance (through for example, a leasing transaction) is an accepted commercial practice in this context.[651] The court did not disapprove of the use of the property by someone who is not the person claiming the benefits of capital allowance, and even went a step further and interpreted the relevant section granting the benefits as being enacted with the view of granting such benefits to lessors so that they would be able to offer lower rates of finance to lessees.[652]

Second, a minimal degree of risk would not, by itself, be regarded as rendering a leasing transaction to be tax avoidance scheme. As long as there is a commercial reason to justify the circularity of funds, it will not, by itself, turn the transaction into a prohibited tax avoidance scheme.[653]

Third, according to the Court of Appeal, denial of capital allowances requires the existence of a clear provision in the tax statutes that limits or prevents the application of the capital allowances legislation. One should not read into the legislation principles or provisions that are not otherwise expressed in it.

Inland Revenue Proposal

In its August 2003 consultative paper, the Inland Revenue has indicated its intention to reform the rules governing the taxation of leasing transactions.[654] According to the Inland Revenue, the current rules lead to inconsistent treatment of similar transactions, resulting in distortions that affect the decision between different types of finance.[655] As part of a more comprehensive debate on capital allowances, the Inland Revenue is considering to amend the distortions by moving the entitlements to capital allowances from the lessor to the lessee in leases, which are essentially finance transactions.[656] For that purpose, a distinction is drawn between a finance lease and an operating lease. According to the Inland Revenue, leasing

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[651] Nash & Gonen (2003) at 113.
[652] Gibson LJ at para. 37 which is quoted above. This, however, has to be examined today in the light of CAA 2001 s.225.
[653] Nash & Gonen (2003) at 113.
[654] HM Treasury & Inland Revenue (2003), para. 2.53-2.60.
[655] *Ibid*, at para. 2.54.
[656] *Ibid*, at para. 2.55.

transactions exist in the wide spectrum between pure financing transactions and basic operating leases. The distortions are created when some of the more developed leasing transactions, which are closer to finance transactions in their substance, are treated as operating leases.

As part of the proposed reform, the Inland Revenue intends to introduce a definition of finance transaction that would includes within its scope some types of the above-mentioned operating leases[657] in order to minimize the distortions. These transactions will be treated and taxed as finance transactions whereby the lessor is not entitled to claim capital allowances and is taxable only with respect to finance elements in its leasing receipts whereas the lessee is entitled to deduct the finance costs out of the rental payments paid to the lessor as part of the finance transaction. In addition, lessees will be entitled to claim capital allowances with respect to the property.[658]

One of the reasons behind the introduction of the proposal is the increasing pressure of EC law on existing law and in particular on the different treatment of leases with UK resident lessees and non-UK (but EU) resident lessees, a distinction that would probably not survive a challenge. Basically, the UK has a choice of two alternatives. First, to treat all leasing transactions alike regardless of the identity of the lessee by granting regular capital allowances to the lessors in all transactions regardless of the identity of the lessee. In effect, adopting such an approach would be favorable to taxpayers and at the expense of the fisc as it will extend benefits also to those transactions that are currently expressly excluded from regular benefits.

A second option is to depart the legal characterization of leases and to move to an economic approach to the characterization on leases similar to the distinction between finance leases and operating leases. If this option is chosen, the UK legislation would follow the economic classification not only for the purpose of timing the payments under the lease but also for determining the nature of the transaction in the first place.

In its 2003 consultative paper the Inland Revenue followed the second option. According to the Inland Revenue, this proposal, which will apply to incorporated and unincorporated taxpayers, is not expected to affect many of the operating leases. If enacted, the proposal will remove the tax distortions between loans and leases that are essentially loans and remove most of the restrictions that currently exist with respect to export leasing transactions, thus

[657] See pp. 181-183 above.
[658] *Ibid*, at para. 2.57-2.58.

increasing the opportunities for UK lessors to engage in leasing transactions to non-UK resident lessees.[659]

US - Characterization and depreciation deductions

The US approach to classification of leasing transactions is based on an economic substance approach whereby the economic substance of the transaction and not the form of the transaction or its label is the controlling element in the classification of the transaction for tax purposes. This general approach is, however, subject to certain exceptions and limitations.[660]

In a true lease, the lessor is the party vested with ownership of the leased asset. According to the economic substance approach, the lessor, being the owner, has to retain substantially all the benefits and burdens of ownership. If, however, substantially all the benefits and burdens associated with ownership are not retained by the lessor, then the lessor is to be treated as if he disposed of the ownership and the transaction cannot be classified as a true lease for US tax purposes.

Congress has chosen not to define a true lease and in absence of statutory definition, the task of defining a true lease and distinguishing it from other types of transactions (e.g. loan, sale (conditional or credit) or provision of services) is left to the courts and to the IRS.

In a true lease, the lessor does not transfer most of the benefits and burdens of ownership to the lessee. The lessor transfers the right to use the asset for a limited time at the end of which the asset returns to the lessor.

The IRS has published its guidelines which provides a set of requirements that have to be satisfied if the taxpayer seeks a ruling that a given transaction is a true lease for US tax purposes.[661] While the IRS has acknowledged that these guidelines should not be seen as a definition of a true lease,[662] it is generally accepted that if a given transaction satisfies these requirements, it is less likely that the transaction will be challenged by the IRS in an audit.[663]

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[659] *Ibid*, at para. 2.59-2.60.
[660] In general, the US approach to tax favors substance to form unless form controls as for example in the recent decisions in *Compaq* and *IES Industries*. For substance over form in general, see McMahon (2002).
[661] *Rev. Proc. 2001-28*, 2001-19 I.R.B. 1156 which modified and superseded *Rev. Proc. 75-21*.
[662] 2001-19 I.R.B. 1156 at section 3. The guidelines are merely a published criteria for advance ruling.
[663] Cozart at 24.

Rev. Ruling 55-540[664] discusses the factors that define a true lease for US tax purposes. Before discussing the specific factors the ruling provides that each case must be decided based on its own particular facts. Nonetheless, based on the history of prior cases, the IRS has formulated a list of factors that the existence of one or more of which can, in the absence of contrary indication, can serve as an indication of a sale and purchase as opposed to a lease.

These factors are the following: first, if the portions of the periodic payments are made specifically applicable to equity to be acquired by the lease. Second, if the lessee acquires title after the payment of a specified amount of rental payments that the lessee is required to make according to the lease agreement. Third, the rental payments provided for in the agreement significantly exceed the current fair rental value. Fourth, the agreement provides an option to acquire the property for a price that is nominal in relation to the value of the property at the time that option is exercised. This criterion is to be determined when entering the original agreement. Fifth, a portion of the rental payment is either recognized as interest or designated as interest. Sixth, the overall amount the lessee is required to pay with respect to a relatively short amount of time is significantly high and close to an amount that would enable the payor to secure transfer of the title to the property.[665]

It is important to note that the ruling provides that the mere fact that the agreement does not include reference or a clause for the passage of title or even expressly precludes such transfer does not prevent a classification of a contract as a sale.

According to *Rev. Proc. 2001-28*, which refers to *Rev. Rul. 55-540* as the relevant authority for classification of transactions as a lease or a sale,[666], in the absence of other facts and circumstances that indicate to the contrary, the following conditions have to be satisfied when applying for a revenue ruling with respect to a leveraged lease:

- The lessor must make a minimum unconditional "at risk" investment in the property equal to at least 20% of the cost of the property. The investment must remain throughout the lease term.
- The lessor has to establish that an amount equal to at least 20% of the original cost of the property is a reasonable estimate of what the fair market value of the property shall be at the end of the lease period.

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[664] 1955-2 C.B. 39.
[665] *Ibid.*
[666] 2001-19 I.R.B. 1156 at Section 2.

- No member of the lessee group has an option to acquire the property at the end of the lease period for less than the fair market value of the property at the time the option is exercised.
- Subject to two limited exceptions that are stipulated in the procedure, the lessee or any of its group cannot contribute to the cost of the property or any improvements made in the property.
- No member of the lessee group may lend the lessor any of the funds necessary for the purchase of the property. This also includes guarantees created with respect to the acquisition of the property by the lessor.
- The lessor has to establish that he expects to receive a profit from the transaction and this profit must result apart from any tax benefits or tax deductions obtained by the lessor as a result of the transaction

In addition, the procedure provides some additional considerations that may be taken into account as for example, limited use property.

Thus, the IRS has taken an economic substance approach by looking, among other things, at whether there is still a linkage between the taxpayer seeking to claim the depreciation deductions on one hand and the responsibility for the risk of loss regarding the property and its residual value on the other hand. This approach is limited by the approach taken by the courts in three specific ways.[667] First, the application of the sham doctrine and its effect.[668]

The second limitation is the decision of the Supreme Court in *Frank Lyon*[669] and its consequences on current characterization issues. The third limitation on the economic approach is the limitations imposed by the courts on the taxpayer's ability to assert economic substance of the transaction to its advantage (the so-called "*Coleman* Rule"). These two limitations are discussed below.

The question of tax ownership has been at the center of many court decisions including the 1975 Supreme Court decision in *Frank Lyon* and more recently the decisions in *Compaq* and *IES Industries*. According to one commentator, the law of leasing is about reconciling two basic themes. The first, that the owner of a property possesses its benefits and burdens. The second theme is that tax law generally respects transactions that are conducted at arm's

[667] Cozart at part I.
[668] According to the sham doctrine, the sham is where the transaction that took place in practice is not the same as the transaction that is contemplated in the relevant documents. As a result, the courts will often set aside this transaction as a sham. Arguably, an appropriate application of the above analysis should confine the application of the sham doctrine to limited exceptional situations.
[669] 435 U.S. 561 (1978).

length with business purpose. The experience of case law in recent years has established a preference of the second theme, sometimes at the expense of the first theme.[670]

A better view is that there is some sort of confusion regarding the meaning of "tax ownership" and this confusion is reflected in some more recent and less recent tax decisions.[671] All of these decisions deal or at least should deal with the concept of tax ownership, although not necessarily in the leasing context. The starting point is economic substance. The essence of this economic substance view is that the lessor retains tax ownership (and thus entitlement for tax depreciations) as long as the lessor retains substantially all the benefits and burdens of ownership, including the risk in the devaluation of the leased asset. As it is suggested below, most of the tax decisions regarding tax attributes of ownership in general and regarding leasing in particular can and should be analyzed based on this analysis of tax ownership and risk, whereby tax ownership follows risk.[672] If this is accepted, then most questions can be determined without need to revert to different types of anti-planning doctrines.

The main obstacle for this approach is the decision in *Frank Lyon.* Although this decision has been significantly criticized over the years,[673] one cannot discuss tax characterization of leases without referring to this decision by the Supreme Court.

Frank Lyon is a sale-leaseback case. The case dealt with a three party transaction, a feature that was central to the court's line of argument. A bank (Worthen) wanted to expand its offices and to acquire new office building. Due to banking regulations restrictions, Worthen was unable to use other means of finance to construct the new office building and resorted to a sale-leaseback transaction whereby it would sell and leaseback the building from a third party.

Frank Lyon (FL) a closely held company was chosen as the buyer-lessor and a third party bank was chosen to help with the finance of the transaction. According to the structure of the transaction, Worthen, the owner of the land on which the building was to be constructed leased the land for a period of 76 years and 7 months to FL. In addition, Worthen sold the building to be built to FL in a sale agreement as part of the transaction, and entered into another agreement with FL, a lease agreement whereby it leased the building for a period of

[670] Cozart at 26.
[671] Kingson (2001).
[672] Kingson (2001).
[673] One practitioner, while commenting on another case (Estmark Inc. v. C.I.R, 90 T.C. 171) wrote the following comment "*Esmark is thought by many practitioners to be the moral equivalent of the Frank Lyon case, a clearly misdecided case that one cites when one's legal position is all but hopeless.*" (Steinberg (1999) at 483).

25 years (primary period) and granted eight options to extend the lease period up to an overall period of 65 years. At the end of this period, unless Worthen were to acquire the building from FL, FL would have full ownership, use and control of the building. The rent obligation on part of Worthen only started upon completion of the building. Thereafter, for the first 11 years rent was set at $145,581.03 per quarter. For the following 14 years, the rent was increased to $153,289.32 per quarter and during each of the option periods (if exercised) the rent reduced to $300K per year. The rent payable over the primary period of the first 25 years equaled the principal and interest payments on the mortgage loan taken by FL from the bank to finance the construction. In addition, FL would have to pay Worthen for the lease of the land. FL also invested $500K and Worthen had a purchase option that priced at the amount of the unpaid loan plus $500K and 6% of interest compounded on this investment.

The issue at stake was the tax characterization of the transaction and the identity of the owner of the building i.e. whether it was a finance transaction or a sale-leaseback transaction, whether FL was entitled to claim depreciation deductions and whether Worthen was entitled to deduct its rent payments. Based on these facts and taking into account the determinations of fact made by the District Court, the Supreme Court held that FL was the owner of the building and that the transaction should be respected as a sale-leaseback transaction. Both its reasoning and its final determination have been subject to criticism. Nonetheless, the decision introduced certain doubts to the tax treatment of leasing transaction in general and sale-leaseback transactions in particular.

First, the court relied on the factual finding of the District Court and respected the finding that the purchase option, for example, was reasonably priced at FMV. Based on this factual finding, the court declined to speculate whether the purchase option would be exercised in the future. On this point, the decision was criticized in two levels. First, at the level of the reliance of the factual finding of the lower court. The court of appeals that reversed the decision of the district court, and in doing so, decided to intervene and look at the factual findings as well on the ground that were clearly wrong. The Supreme Court was reluctant to do so and mentioned that as an appellate court it is only dealing with questions of law, relying on the factual findings of the district court. In doing so, it failed to address the question whether these findings were erroneously, wrong as it was decided by the Court of Appeals.[674]

[674] Cozart at 49.

"The Supreme Court treated the Eight Circuit as having simply mistaken a factual for a legal issue and did not discuss whether the district court's finding was clearly erroneous. In comparison to the lengthy discussion of residual values in subsequent lease cases, the district court's analysis is manifestly inadequate."[675]

One can only infer that their reluctance to intervene can be regarded as an implied indication at least that they did not think so. This raises another question – was the factual determination that the purchase option represented a reasonable market value a sound determination? Arguably, the fact that the court based its decision, even if in part, on the basis that the purchase option was reasonable and at FMV and thus refused to speculate whether it would be exercised limits the application of this decision only to cases where similar determination can be made.

Second, the court seems to have combined the sham doctrine with the question of tax ownership and discussed these two separate and unrelated issues together.[676] Kingson, while referring to an earlier commentary written by Del Cotto, comments as follows:

"As Professor Del Cotto puts it, the problem with interpreting Lyon arises 'from both the multiplicity of factors relied on by the Court and its failure to rank them in importance.' He adds that the Court confused 'business purpose with economic reality'. In other words, the Court put the business motivation for leasing – the banking regulators – ahead of economic terms of the lease itself."[677]

The decision, according to the Supreme Court was based on the following reason,

"In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued by tax-avoidance features that have meaningless labels attached, the government should honor the allocation of rights and duties among the parties."[678]

Third, it appears that the Supreme Court has examined the wrong type of risk in analyzing whether FL undertook sufficient risks and rewards that would constitute tax ownership. In analyzing whether the lessor retained the burdens and benefits of ownership, the court should have looked at whether the lessor bore the risk of loss as a result of decrease in the value of

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675 *Ibid.*
676 Kingson (2001).
677 *Ibid.*
678 *Frank Lyon v. Commissioner* as quoted by Kingson (2001).

the asset. Instead, ironically, the court focused on the risk of loss that was in fact a credit risk, whether there is a risk that the lessee would default and fail to satisfy its obligations under the lease, a risk that is usually associated with loans.[679]

The impact of the decision is hard to quantify. It appears that some courts have been quite reluctant to derive and apply principles from the decision in Frank Lyon.[680] At the same time,

"Despite this reluctance in some quarters to ascribe much importance to Frank Lyon, the decision has established judicial recognition that, within limits, the parties' choice of a form of a transaction governs its tax consequences. Inasmuch as this proposition has been recognized in other areas of the tax law, the appropriate inquiry regards only the extent to which it should be followed in leasing cases. While this proposition has appeared in dicta in several leasing cases, it is understandably difficult to determine its exact impact."[681]

According to LeDuc, *Frank Lyon*, being a highly ambiguous case, presents uncertainties in application to other leveraged leasing cases. First, it appears that it only applies to multi-party transactions. The fact that the transaction in *Frank Lyon* was a multi-party transaction is emphasized in the decision of the Supreme Court that distinguished in its analysis other, non multi-party cases. Second, it is not clear whether the Supreme Court applied the substance analysis or was it more concerned with the form. This uncertainty results, to a large extent, from the court's unwillingness to apply the decision in *Lazarus* where the court did apply the substance analysis.[682]

According to LeDuc, lower courts following the decision in *Frank Lyon* applied a two prong test: first, the court determined whether the transaction is a sham transaction devoid of economic substance. Second, if the transaction does not fall within the application of the sham doctrine, the analysis is to determine whether the lessor acquires / retains the requisite level of the benefits and burdens of ownership.[683]

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[679] Del Cotto (1981-1982) at 4. Del Cotto goes on and list four additional points central to the Court' reasoning in Lyon. First, the decision seems to suggest that three-party deals involve a purchase whereas two-party deals involve a loan, a suggestion that according to Del Cotto has no foundation in theory. Second, the Court overlooked the fact that Lyon had an expectation with high likelihood to receive part of the funds back. Third, based on the district court's determination, the option was assumed to be at fair market value thus not granting Worthern any equity in the building. This determination strikes at the heart of the government position. Fourth, the transaction was neutral for the government who did not care whether it was Worthen or Lyon who was the owner of the property. It is not clear, however, how this reasoning fits with the tax issues at stake (Del Cotto, at 41-43).

[680] Cozart at 49 referring in particular to the decision in *Transamerica Corp. v. US* where the tax court rejected the Frank Lyon based argument holding that the taxpayer interpreted the decision too widely.

[681] Cozart at 50.

[682] LeDuc, (2002) at 277-278.

[683] *Ibid*, at 278-279.

The third limitation on the use of the economic substance approach deals with the ability of the taxpayer (or precisely, the taxpayer's inability) to argue for substance over form. Also known as the Coleman rule, there appears to be a line of precedents (based on the decision in *Coleman v. Commissioner*) that limits the taxpayer's ability to argue for substance over form only to cases where a higher standard of "strong proof" is satisfied.[684] According to this rule, the taxpayer seeking to argue for the application of the economic substance standard and to revoke its form has to show that there is a strong proof for preferring such economic substance approach to the apparently contradicting form of the transaction as evidenced from the contracts and documentation. Sometimes, this claim is forced due to non-tax reasons where the taxpayer is required to pass legal ownership (title) due to regulatory reasons or other requirements. This is, probably, the most challenging US tax obstacle which applies to double-dip leasing because the taxpayer is seeking to be taxed according to the economic substance of the transaction as opposed to its form.

Availability of Depreciation Deductions

§167(a) allows for depreciation deductions which according to §168(a) will be determined in the case of tangible property by using the applicable depreciation method, the applicable recovery period, and the applicable convention.[685]

To allow businesses to claim depreciation expenses with respect to capital assets that are used in their trade, Congress enacted the ACRS legislation in 1981, a favorable accelerated mechanism that provides taxpayers with quicker depreciation pace (vis-à-vis regular economic depreciation). This legislation was intended to provide the "investment stimulus that is essential for economic expansion".

Not all assets, however, may benefit from this legislation. Some assets, for example, those used predominantly outside the US, those leased to a tax-exempt entity and those financed by a loan that has tax-exempt interest, are required to use the alternative depreciation method (ADS), the straight-line method, as their depreciation method. [686] These limitations are further discussed below.[687]

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[684] There is a view that the stronger burden of proof rule of *Danielson* should apply where the taxpayer seeks to invoke the economic substance of the transaction to his support while revoking the form of the transaction. This view is not shared by leading commentators who support the view that in the context of leasing transactions, it is sufficient if the taxpayer satisfies the less stringent "strong proof" requirement of *Coleman.* See generally, Shrank & Gough (2003) ¶25-141 – 25-150.
[685] IRC §168(a).
[686] IRC §168(g).
[687] See pp. 204-207 below.

Effect of different characterization in foreign law

As it is discussed above, the US has taken an economic approach to the characterization and the taxation of leasing. This approach is based on all the facts and circumstances surrounding the transaction and is aimed at understanding who is the true owner of the leased asset from an economic perspective and whether there has been a transfer of the ownership from the lessor to the lessee. It is thus quite interesting to understand the weight, if any, which is given to the characterization in other jurisdictions.

In *TAM 9748005*[688] the Service indicated that it, in general, does not regard the classification of the transaction in the foreign jurisdiction as having a bearing on the characterization of the transaction for US tax purposes. Moreover, the Service indicated that the fact the foreign entity is regarded as the tax owner of the property for the foreign jurisdiction's tax purposes would not prevent the US taxpayer from being considered as the tax owner of the property for US tax purposes.[689]

"This dual ownership will not will not be a concern in the United States when it is solely the result of differing US and foreign legal standards of tax ownership being applied to the same facts because tax ownership is determined under U.S. legal standards without regard to the tax ownership treatment obtained under foreign law. Thus, the United States need not be concerned where the taxpayer in a cross-border transaction is able to show that the same facts that led the foreign taxing authorities to conclude that ownership lies in the foreign party, also support the conclusion that the taxpayer is the owner under U.S. standards."[690]

At the same time, there are situations where dual ownership or inconsistent treatment might be a reason for concern.

"A concern with dual tax ownership arises, however, if the U.S. and foreign legal standards of tax ownership are the same, or if it is unclear whether and the extent to which they differ. Under those circumstances, putative dual tax ownership of the same property might result from facts being represented differently to the respective tax authorities. Moreover, the government facts a significant challenge in ascertaining the correct facts governing the substance of a transaction when key evidence is located outside the United States."[691]

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688 1997 WL 734312 (IRS TAM).
689 A few years before the issuance of TAM 9748005, the courts took a similar position. In *Illinois Power v. Commissioner* 87 TC 1417 to which the IRS published its acquiescence (AOD CC-1990-94).
690 *Ibid.*
691 *Ibid.*

The latter situation referred to by the government is, it is submitted, a situation of tax evasion rather than ITA, as the taxpayer either represents a different set of facts to each tax authorities or omits certain facts in its report to the tax authorities. Thus, where the taxpayer is providing the tax authorities with the full facts of the case and does so in a consistent manner, the dual ownership can only result from having different legal rules in the different jurisdictions. In this situation, as indicated above, the Service does not see any reason for the foreign treatment to have any bearing on the US treatment.

UK - Cross-Border Leasing – Specific Measures[692]

In a recent leasing decision, the Court of Appeal reviewed the origin and development of capital allowances in the UK tax legislation. The starting point is that absent a clear provision in statute, no allowance or deductions can be claimed against capital assets. This is the general rule.[693] This general rule operated as a disincentive to the acquisition of capital assets by businesses. Thus, in 1878, a special provision allowing deduction with respect to deprecation or "wear and tear" was introduced[694] in order to achieve fiscal neutrality.

Only in 1945 was a positive tax incentive added to the tax legislation. A first year allowance equal to one fifth of the expenditure made with respect to acquisition of a plant or machinery for the purposes of a trade coupled with an annual allowance in subsequent years equal to five-fourths of the amount that would be allowed as "wear and tear" were allowed as depreciation. The incentive was in the form of the additional 25% given over the appropriate commercial amount. This regime remained unchanged until the legislation of the Finance Act 1971. That year, a 100% first year writing-down allowance was introduced and the link with the appropriate commercial amount of the "wear and tear" was broken.[695]

In most of the 1970s and the beginning of the 1980s, the UK leasing industry saw a rapid boom, especially in the area of export leasing out of the UK, mostly due to the availability of generous first year capital allowances for expenditure on plant and machinery.[696] The perceived problem with this situation was that non-residents those who effectively enjoyed it, an outcome that was incompatible with the rationale behind the introduction of generous capital allowances in the first place.

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692 While an in-depth analysis of the UK treatment of outbound and inbound cross-border leasing is outside the scope of this work, a brief overview of the applicable provisions can shed some light on the approach taken in the UK with respect to the taxation of cross-border leasing and its rationale and can assist us in illustrating our point.
693 *BMBF v. Mawson* [2003] EWCA CIV 1560 (8) referring to Income Tax Act 1842 s.159 now Income and Corporation Taxes Act s.74 and s.817.
694 Customs and Inland Revenue Act 1878, s.12.
695 *BMBF v. Mawson* [2003] EWCA CIV 1560 (8).
696 See generally, Lindencrona & Tolstoy (1990) at 590.

As a result, *"[F]requently, lessees would be situated in the United States and obtain tax depreciation allowances there as well as the indirect United Kingdom benefits. United Kingdom exchange control restrictions provided a check on export leasing: the Bank of England might refuse consent for transactions unless allowances were waived or deferred. A prompt legislative response was therefore required following the lifting of exchange controls in 1979."*[697]

This was done in Finance Act 1982. The UK tax treatment of outbound cross-border leasing has changed dramatically with the introduction of what is now Sections 109 and 110 CAA 2001 that were originally introduced in FA 1982.[698]

This legislation was intended to limit the fiscal incentive otherwise granted by the capital allowances in situations where it was thought to be too generous. The limitation is designed either to achieve a situation of fiscal neutrality with respect to some leases or to create fiscal discouragement in the case of other leases.

Prior to the introduction of the legislation, it was possible for a UK lessor to engage in a leasing transaction with a non-UK resident lessee and to enjoy the benefit of capital allowances in the UK while the asset was used in a foreign country by a foreign end-user. The Government felt that it was basically financing the costs of acquisition of non-UK purchasers who chose to acquire the property by way of a lease with a UK lessor and that a certain measure has to be adopted to prevent this loss of revenue.[699] [700]

As a result, the new legislation substantially reduces and even eliminates the amount of capital allowance available for UK lessors when the property leased is used by a non-UK lessee outside the UK. The legislation that started with FA 1982 and culminated in the two Finance Acts of 1997[701], removed almost completely, the benefits of export leasing.

If the legislation applies with respect to a transaction, the percentage of writing down allowance per year is reduced to 10% or even nil, so that it is sufficient to shelter rental

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697 Clayson (2002) at 11-3.
698 Prentice (1990) at 590-591.
699 Clayson (2002) at 11-19 (*"The intention behind the legislation was .... 'not to allow it to milk the Revenue'. Nonetheless, few United Kingdom – to – foreign leases relying upon United Kingdom capital allowances have been written since 1982."*).
700 See also Nash (2002) at 418.
701 Finance Act 1997, Finance Act (no. 2) 1997.

income from the lease, if at all, but does not result in a loss. The legislation has a few exceptions, mainly to leasing of specific types of equipment and to certain short-term leases.

"Overseas leasing does not include situations where the leasing is 'short-term leasing' or where a ship, aircraft or transport container is leased and used for a 'qualifying purpose' by virtue only of the extension for certain such assets. In these circumstances, the special rules do not apply and the usual pooling arrangements and 25 per cent writing-down allowances apply instead whilst the claim for the normal allowance (or the relevant company return) must be accompanied by a certificate setting out the description of such 'permitted leasing', the identity of the lessee and the assets in point."[702]

The general allowance is 25% per year and it is provided to the legal owner of the property.[703] If s. 109 applies, the allowance is restricted to 10%. The rationale behind this limitation was to allow sheltering of the rental income received from the lease but not to allow sheltering of any other income not related to the lease.[704] For this section to apply two conditions have to be satisfied. First, the plant or machinery has to be, at any time during the designated period,[705] used for overseas leasing which is not a protected leasing. Second, the expenditure is not long-life asset expenditure. Plant or machinery is regarded as used for overseas leasing if it is used for the purpose of being leased to a person who is not a resident in the UK and does not use the plant or machinery exclusively for the purpose of earning profits chargeable to UK tax. In other words, it covers all "export leasing". A lease is a "protected leasing" and thus outside the scope of s 109 if it qualifies as a short leasing (within the scope of s 121) or if it is a lease of a ship, aircraft or a container and it is made for a qualifying purpose according to s 123 (ships and aircrafts) or to s. 124 (transport containers).[706]

If s. 110 applies, the allowance is reduced to zero and is disallowed completely with respect to the plant or machinery that is leased in the lease that is subject to the application of this provision. For s 110 to apply, four cumulative conditions have to be satisfied. First, the expenditure has to be incurred on the provision of plant or machinery for leasing. Second, the plant or machinery has to be used, at any time during the designated period, for overseas

[702] British Tax Library, para. 651-175 – Assets leased outside the UK.
[703] Clayson (2002) at 11-13 – 11-14 (the ownership requirement is in CAA 2001 s.11(4)).
[704] Clayson (2002) at 11-20.
[705] "Designated period" is defined as the shorter of 10 years period beginning with the date on which the plant or machinery was first brought into use and the date on which the person who incurred the expenditure ceases to own the plant or machinery (CAA 2001 s. 106(1), (2)).
[706] CAA 2001 s 105(5); British Tax Library, para. 651-175 – Assets leased outside the UK.

leasing.[707] Third, the plant or machinery has to be used for a purpose that is not a qualifying purpose.[708] Fourth, the lease satisfies one of the conditions listed in the list that is included in s. 110.[709]

The main difference between the two categories lays in the nature of the lease. S. 109 generally applies where the lease is not a finance lease and therefore a writing-down allowance of 10% would usually achieve the goal of fiscal neutrality, allowing the lessor to write off his expenditure over a period of approximately 15 years during which he is expected to receive a matching income which will be taxable in his hands.

S. 110, on the other hand, applies to finance leases where the nature of the lease violates the fiscal neutrality because the rental stream will not result in a taxable income in the hands of the lessor. As a result, to avoid the possibility that capital allowances are allowed although the rental income is not taxed in the hands of the lessor, s. 110 denies the entitlement for these allowances altogether.[710]

"The withdrawal of writing-down allowances altogether is a fiscal disincentive, calculated to discourage the owner from incurring the expenditure in the provision of the machinery or plant for leasing to a non-resident on the terms of a finance lease; or for leasing on the terms of a finance lease to a lessee who is not a non-resident if, at any time during the requisite period, the plant or machinery may be used for the purpose of being leased (by that, or a subsequent, lessee) to a non-resident. But, in a single lease case, that discouragement is removed if the machinery or plant is to be used by the non-resident lessee for a qualifying purpose… . that is to say if he is to use the machinery or plant for the purposes of a trade, otherwise than for leasing, in circumstances in which, if he had bought the machinery or plant himself (instead of leasing it) he could have claimed a first-year allowance or treated his expenditure as qualifying expenditure."[711]

[707] These two requirements are also applicable with respect to s. 109 discussed above.
[708] A "qualifying purpose" as defined by s 105(6) as including any activity included in s 15(1) even if the profits or gains from such activity are not chargeable to tax. In addition, ss. 121 and 122 provides for certain types of short-term leases that are regarded as made for a "qualifying purpose", ss. 123 and 124 provide the same for certain leases of ships, aircrafts and containers and s. 125 for other types of leases which can be regarded as made for a qualifying purpose.
[709] CAA 2001, s 110(1)(d). Among the conditions: (1) the lease is for a period of more than 13 years, (2) the lease (or a separate document) make it possible, through an extension or a new lease, to extend the overall period of the lease to be more than 13 years, and (3) there is a period of more than one year between the dates of the making of two consecutive payments under the lease.
[710] [2003] EWCA CIV 1560 (18).
[711] [2003] EWCA CIV 1560 (19).

Outside the scope of these limitations are leases of ships, aircrafts, and transport containers as well as certain short-term leases, all of which are leases that Parliament decided should be eligible for the full capital allowances although the equipment is outside the UK.[712]

In effect, the legislation reduced almost completely the attractiveness of the UK as a location for lessors for outbound leasing[713] and thus the attractiveness of the UK for outbound double-dip leasing transactions. It should be noted that the legislation was not designed to target outbound double-dip leasing specifically but was wider in its scope and sought to cover all but a limited number of outbound leasing transactions.

"Section 42 has effectively cut off the UK leasing industry from an important market of offering lease finance to non-UK lessees and the decision in No. 24 case[714] *has not helped that position. Even if the lessors are able to structure their leasing agreements to comply with overseas leasing rules (which is unlikely), they are still likely to find that they are unable to access the domestic leasing market to finance a lease to a non-UK lessee."* [715]

At the comparative level, it is interesting to note that many European countries do not have comparative rules that distinguish between the treatment of outbound leases and the treatment of domestic leases.[716] This point is in line with EU tax requirements and shall be further developed below.[717]

With respect to the UK legislation, it is questionable whether these measures are able to survive an EC tax challenge as it distinguishes between non-resident and resident lessees in the availability of capital allowances. The legislation refers to the place of use of the leased asset for determining the extent of the application of s. 109 and 110 (discussed above) and it is likely that such legislation would be regarded as incompatible with the provisions of the EC Treaty.[718]

"The reason why sections 109 and 110 might be considered illegal as a matter of EC law is that their effect is, prima facie, to discriminate against non-UK lessees. Several principles of EC law may be applicable here, including freedom of establishment... . freedom to provide

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712 CAA 2001, ss. 121, 123, 124.

713 *Ibid.* See also Nash (2002) at p. 418 (*"although in recent years some leases to non-residents have been written which yield an economic return to the lessor even where the lessor's allowances have been restricted to 10%")*.

714 BMBF (No. 24) v. IRC. The reference is to the High Court decision, which was later affirmed, to a large extent by the Court of Appeal.

715 Nash & Gonen (2003) at 120.

716 Clayson (2002) at p. 11-19.

717 See pp. 242-245 below. This approach is also reflected in the Inland Revenue 2003 reform proposal that is discussed above (pp. 186-188).

718 See also, Clayson (2002) at 11-20.

services.... . and free movement of capital. The Treaty, may therefore, be infringed if sections 109 and 110 create a disadvantageous pricing environment either from the perspective of a lessee purchasing leasing services or from the perspective of the lessor selling on a cross-border basis. ... . Moreover, there are some recent cases, which cast doubt on the potential justifications for any such discrimination."[719]

In this respect it is interesting to note two recent decisions of the ECJ, *Lankhorst-Hohorst* and *Bosal Holding*. In both decisions, the ECJ held that the erosion of the tax base is not a valid reason for justifying a legislation that is incompatible with the EC Treaty. In both cases, anti-planning legislation[720] was held to be incompatible with the EC Treaty as it treated residents and non-residents differently. An argument that the legislation was needed to prevent the erosion of the tax base of the MS involved was not accepted as a valid justification of public policy that would allow the acceptance of an incompatible measure. Moreover, in *Eurowings*, the ECJ rejected an attempt on part of a MS to impose discriminatory measures on a taxpayers based on the difference in treatment of the transaction, a cross-border lease, in the other country. This case is of particular importance as it dealt with cross-border leasing and with situation whereby a certain type of cross-border lease is more advantageous than a domestic lease due to the tax treatment in the foreign country (a lower rate of tax) which makes the tax treatment of the entire transaction more beneficial than the tax treatment of a domestic transaction.[721]

The situation is a bit different with respect to inbound cross-border leasing. The availability of capital allowances to the users under a hire purchase agreement makes it possible to structure a transaction in way that would allow both the lessor and the lessee (user) to enjoy capital allowance or deprecation with respect to the same equipment.

"In the international leasing arena, this regime provides, from the United Kingdom perspective, what are perhaps the most important tax planning opportunities. In particular, it is possible to structure a transaction in such a way that deprecation tax allowances are taken both in the United Kingdom and an overseas jurisdiction: actual ownership is relied upon overseas and deemed ownership in the United Kingdom (hence the expression 'double dip'). Thus a United Kingdom user of equipment, even one in a full taxpaying position, can

[719] *Ibid.*
[720] Thin-capitalization legislation and interest allocation legislation, respectively.
[721] See generally also, Clayson (2002) at 11-20. This pressure led the Inland Revenue to introduce a reform proposal to the taxation of leasing transactions above (pp. 186-188).

improve its cost of funds by means of sharing in the tax allowance available in more than one country."[722]

There appear to be no specific measures to prevent or restrict a person regarded as the tax owner of the equipment for UK tax purposes from claiming depreciation allowances with respect to equipment that is leased within the UK or that is within the charge to Corporation Tax in the UK.

"While the UK is rarely used for outbound leases, because of the restriction of WDAs to 10% under Chapter 10 of Part 2 of CAA 2001... ., UK lessees can benefit from double-dip leases by acquiring equipment on hire purchase terms from lessors in certain overseas territories or by using certain other structures.

In structuring such transactions there is often a conflict between the requirements to satisfy the economic ownership requirement in one jurisdiction and the requirement for the UK lessee to have a nominal purchase option at the end of the lease."[723]

In the case of a lessee, in order for the lessee to be able to claim the capital allowances, the lessee would have to establish that he is indeed the tax owner or deemed tax owner, thus eligible to claim the allowances. In these situations, the restrictions discussed above in the context of hire purchase would apply.

From a UK country perspective, this attitude appears to be quite logical as it corresponds with the rationale behind the grant of the benefit in the first place, i.e. to encourage acquisition of assets that are being used in the UK.

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[722] Clayson (2002) at 11-2.
[723] Nash (2002) at 423.

US - Cross-border Leasing - Specific Measures[724]

At the cross-border level, a distinction has to be drawn between the treatment of outbound cross-border leasing transactions and the treatment of inbound cross-border leasing transactions.

On the outbound side, there appears to be a tension between competitiveness of US lessors on one hand and the desire to preserve revenues and prevent exportation of tax benefits to foreign taxpayers on the other hand. Another element that should be included in the analysis is the "cat and mouse" game between the taxpayers on one hand and the government on the other. As a result, a complex set of rules was created, not always with a clear intention behind it. These rules apply whenever a US lessor is engaging in a cross-border lease with a non-US lessee.

"Cross-border leasing structures exist in a very dynamic market. U.S. investors and their advisors are constantly modifying and improving these techniques, and devising new ones. At the same time, the IRS, the Treasury Department and Congress continue to modify the laws, regulations and other authorities governing these transactions. These activities at time result in further limitations on existing structures and at times (sometimes the same times) provide new opportunities for structuring outbound leases."[725]

Prima facie, it appears that the US, like the UK, was not willing to allow the export of tax benefits to non-residents, thus resulting in revenue loss. At the same time, there were certain transactions in which the leasing portion was regarded as the tool rather than the end result. As a result two apparently contradicting pieces of legislation were adopted. On one hand, the US adopted rules that extended the period over which the depreciation deductions must be taken with respect to leasing with non-US residents lessees and limited the amount of depreciation that can be claimed each year. The intended result was to make outbound cross-border leasing not beneficial economically.

On the other hand, US lessors were able to make use of the US export incentives to make the cross-border leasing transactions more attractive. These incentives only apply in limited circumstances and the US lessors were required to comply with the requirements of the applicable legislation to enjoy its benefits. This legislation, first Domestic International Sales Corporation legislation (DISC), then the Foreign Sales Corporation legislation (FSC) and

[724] For a comprehensive analysis of these rules, see generally, Shrank & Gough (2003) chapter 25.
[725] Shrank & Gough (2003) at 25-14.

later the Extraterritorial Income (ETI) legislation applied usually when the leased asset was manufactured in the US.

By its terms, the application of either FSC or ETI resulted in the exclusion of a certain part of the US lessor's income from tax in the US, thus making it more beneficial to engage in outbound leasing transactions and enabled the lessor to pass some of the benefits to the lessee, the user of the equipment, thus encouraging export of US equipment.

A good starting point for our discussion is 1984, a year in which two important changes were made to the tax Code. The first change introduced the export incentive in the form of the FSC legislation that was drafted wide enough to apply to export leasing by US manufacturers. The FSC replaced the DISC legislation which was held illegal by the WTO. The second change was the introduction of the Pickle Regulations that were meant to deny the benefits of accelerated depreciation benefits from lessors in export leasing.[726]

The apparent rationale behind the second legislation was to make leasing to tax exempt entities unattractive. This was done by extending the period with respect to which depreciation deductions are calculated on one hand and by limiting the rate of the depreciation deductions on the other hand (moving from an accelerated depreciation system to an alternative straight-line depreciation method).

"*Almost since the inception of the incentive depreciation systems – beginning with ADR in 1971 and continuing through ACRS in 1981 and into MACRS in 1986 – property used predominantly outside the U.S. has been ineligible for the maximum incentive provided by the then-current depreciation regime. Under MACRS, such property (along with "tax-exempt-bond-financed-property" and certain property imported from countries maintaining discriminatory trade barriers against the U.S.) must be depreciated under the "alternative depreciation system" (ADS) provided by s.168 (g) of the Code.*"[727]

Park, however, argues that the rationale behind the legislation in 1984 was not to discourage export leasing but rather domestic leasing with tax-exempt entities (such as, government and local governments). Thus, "*Congress was primarily concerned with limiting lessors' use of accelerated depreciation in leases involving domestic tax-exempt leases. Congress did not*

[726] Shrank & Gough (2003) at 25-8.
[727] *Ibid*, at 25-15.

explicitly address the question of whether foreign lessees in FSC leases should be excluded from section 168(g)."[728]

According to Park, the legislation should be amended so it does not apply with respect to export leasing transactions that qualify under the FSC (or ETI) legislation. He bases his arguments on the distinction between domestic leasing transactions with tax-exempt entities and export leasing transaction between US manufacturers and foreign lessees of US made products. Whereas the former reduced the US revenue base, the latter has the advantages of promoting US goods and products abroad, making them more competitive vis-à-vis comparable products from other countries and supporting the US manufacturing industry. In addition, the US Congress did not intend to limit the benefits of export leasing by US manufacturers and this is evidenced in the legislative history.[729]

Although according to the ADS the property was only eligible to the less beneficial straight-line method of depreciation and although the recovery period taken into account under the ADS was the longer period of the property's "class-life" (as opposed to the shortened depreciable lives applicable to most MACRS), it was still possible to obtain a beneficial lease transaction by applying the FSC rules and some other measures.[730]

These techniques were successful in dealing with the provisions of the original legislation and regulations but not for long. New regulations that were introduced in 1995 and finalized in 1996 included the term of the replacement lease transaction within the term that has to be taken into account for determining the "lease term" according to the Pickle Regulations. In effect, the new regulations took out the benefit in using replacement leasing transactions.

These regulations were criticized as being contrary to the object and purpose of the legislation that was first introduced in 1984.[731] As discussed above, the legislation was targeted primarily at domestic leases with tax-exempt entities and not at export leasing to

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[728] Park (1996) at 304-305.
[729] *Ibid.*
[730] Shrank & Gough (2003) at 25-15. Post-1984 and Pre-1996 transactions had four main advantages that helped them remain economically viable. First, due to the application of FSC regime, 30% of the income was exempt from tax at the hands of the lessor. The lease was made by using a FSC which was only subject to tax with respect to 70% of its gross income. In addition, dividends paid by the FSC to its US parent company were not subject to further tax. Second, the leased property was held on a trust held by the US parent company of the FSC. As a result, the US parent company was able to claim depreciation deduction against its taxable income. Third, to remove part of the effect of the 1984 legislation, the parties use a replacement lease technique that was meant to accelerate the pace of the depreciation deductions that as a result of the then new s.168(g) was calculated on a straight-line basis. At that time, the term of the replacement lease was not included in calculating the depreciation and the taxpayers were able to shorten the period and increase the pace of the depreciation. Fourth, the US parent usually financed its investment in the FSC with a third party loan and was able to claim depreciation deductions with respect to that loan (see generally, Park (1996) at 302).
[731] Park (1996).

foreign lessees. The reason export leasing transactions were included in the legislation was "*to provide equal treatment of similar transactions, with the reservation that a favorable tax treatment of U.S. equipment leased to foreign lessees may be effective in "encouraging the foreign use of American-made products.*"[732]

Thus, adopting regulations that would reduce the benefits of export leasing transactions would be to apply §168(g) in a manner that was not explicitly set out in the statute or its legislative history.[733]

Unlike the pre-1984 situation, in 1995 only US manufactured assets were involved in export leasing. Otherwise, these leasing transactions would not qualify for the FSC benefits. Adopting legislation that would make the leasing less beneficial, it was argued, would result in damaging the competitiveness of US manufacturers abroad.[734] As a result of the regulations, US manufacturers would no longer be able to offer US products in relatively low price due to the tax incentives available through leasing.

Today, with the requirement to repeal ETI, export leasing becomes even less attractive.

Inbound cross-border leasing transactions are subject to similar requirements as outbound cross-border leasing transactions necessary for the establishment of a different characterization in the US and in the foreign jurisdiction. However, unlike outbound or export leasing transactions, inbound leasing transactions are not subject to the application of the Pickle Regulations (or other similar provisions) that might restrict or defer the availability of the depreciation deductions. At the same time, these leasing transactions cannot benefit from the application of the ETI legislation (or its successors). In addition, where the transaction involves more than one tier, it is possible that the anti-conduit regulations may apply.

Recently, following the discussion on corporate tax shelters and as part of Temporary Regulations 1.6011-4T(b)(3)(i)(E), it is now necessary for taxpayers engaged in transactions which adopt an inconsistent tax treatment in the US and in the foreign tax jurisdiction to report this inconsistent treatment as part of the report of the transaction.

[732] *Ibid.*
[733] Park (1996) at 315.
[734] *Ibid* at 316-317.

Summary

Different systems grant depreciation benefits to certain taxpayers as a method for encouraging investment and acquisition of capital assets to be used in business. In most countries, the depreciation deductions (or their equivalent) are structured in a way that is more favorable than the true economic depreciation of the asset acquired. In that way, taxpayers entitled to the benefit receive their deductions earlier than they would be entitled to under economic depreciation.

The entitlement of the depreciation deductions is based on the satisfaction of a certain criteria by the taxpayer claiming the benefit. In most cases, it is an ownership requirement whereby the taxpayer is asked to qualify as the owner of the property. In each jurisdiction the test is applied in a different way. Some jurisdictions, like the US for example, favor the economic substance approach and will follow it subject to certain restrictions on the way taxpayers may assert the use of the substance over the form. Other systems, like the UK for example, favor a more legalistic approach and will tend to treat the legal owner of the property as the true owner of the property. Yet other jurisdictions may favor an approach that follows the accounting principles and grant the benefits to the owner of the property based on an accounting based determination. The UK has announced its intention to adopt this approach instead of its existing legalistic approach.

In all these situations, the treatment of the other party to the transaction in her own country is irrelevant for the determination.

Given this approach, it appears that the cross-border leasing where both parties are entitled to claim depreciation deductions does not necessarily stand against the rationale behind the grant of the deductions in the first place. First, the grant of the depreciation deductions is not dependant on the treatment of the taxpayer or its counter-party in another jurisdiction. In the US, for example, West has commented that "*it is not an explicit condition or implicit premise of the U.S. depreciation rules that the same property not be depreciated by another taxpayer under the laws of some other country. Therefore, the United States has no legitimate tax policy objection to a double dip lease based on the fact that foreign law allows depreciation deductions based on legal principles inconsistent with those of U.S. law.*"[735]

Moreover, as it can be seen in some jurisdictions, there are certain leasing transactions to which the legislator did not wish to grant depreciation deductions. For example, some types

[735] West (1996).

of export leasing. In these situations, the legislator has acted explicitly to deny or limit the availability of the depreciation benefits regardless of whether these benefits are available in the other jurisdiction.

Second, the grant of the depreciation benefits suits the general purpose of the deprecation legislation, to encourage the acquisition of capital assets by taxpayers for the use in their business. As Ring notes, the real benefit in double dip leasing is not necessarily the second entitlement for deductions that is granted to the counter-party but the pace in which this second set of deductions may be claimed.[736] Nonetheless, even though the entitlement to an accelerated second set of deductions is in line with the general concept underlying the legislation it may nevertheless be contrary to the specific scheme adopted by the legislator. For example, if we assume that in enacting the depreciation legislation, the legislator had in mind an internal structure whereby one type of asset is entitled to be depreciated over 10 years whereas another type of asset is entitled to be fully depreciated over 20 years, allowing some assets that may gain from double-dip leasing to benefit from the favorable treatment in both jurisdictions has the potential of disturbing the internal structure of the depreciation scheme the legislator had in mind when enacting the legislation and may lead to equity and efficiency distortions.

There is, however, no explicit support for this approach to the legislation. Moreover, existing practice, especially in the US, does not seem to support this approach. In a recent revenue ruling that is also mentioned above,[737] the IRS did not oppose to the existence of the double-dip leasing per se and the above-mentioned internal structure argument was not raised. In practice, then, the correct approach should be the approach taken by West, mainly on the basis that the entitlement to the depreciation benefits is determined by each jurisdiction based on an independent inquiry made in that jurisdiction according to its domestic principles and without reliance, implicit or explicit, on possible determination by other jurisdictions.

At this stage, it is necessary to determine whether there are valid policy reasons that justify the change of this policy. At this stage, the discussion is divided into discussion of outbound transactions and discussion of inbound transactions as policy considerations may vary from one type to the other.

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736 Ring (2003).
737 See p. 196 above.

Chapter 8 - Discussion

Looking at the limited existing literature on ITA, we can identify several approaches that were taken. The starting point is probably with Rosenbloom's starting argument that in the absence of an international tax system, there is arguably no objection to ITA which is the natural result of the differences between the tax systems, differences that result, in many situations, from a different approach to taxation of certain transactions.

One of the comments made by Rosenbloom in his lecture was that ITA is not worse than other existing opportunities that exist and that are not challenged. If this is so, why should ITA be discriminated against?[738]

Apart from challenging the existence of a problem, Rosenbloom also challenged the feasibility of a solution, should ITA be recognized as a problem worth restraining.[739]
Avi-Yonah's comment on Rosenbloom's lecture once again focuses on ITA as a unified phenomenon and arguing that ITA should be objected to based on three leading principles, efficiency, equity and revenue loss.[740]

Shaviro recognizes that there is no need for harmonization to deny ITA and that each ITA situation should be examined based on its own merit thus rejecting the "all or nothing" approach with respect to ITA.[741] He also recognizes the difference in approach between intended subsidies as he refers to it and general rules of classification. The former, like for example, depreciation deductions in leasing, are measures that are usually adopted following an intentional policy and a reaction on the part of a foreign country to deny such benefits might deliberately reverse another country's express economic policies exposing the US to a possible retaliation from that other country.[742]

Thus, unilateral action should be limited to situations which are win-win situations where the intervention raises both the national and international efficiency. Intervention is not warranted when it would make bad policy to intervene. This, however, is a question to be decided on a case-by-case basis.[743]

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738 Rosenbloom (1999-2000).
739 *Ibid.*
740 Avi-Yonah (1999-2000) at 171.
741 See also Edgar (2003).
742 Shaviro (2002) at 326.
743 *Ibid* at 326.

His focus is on the more economic side on the discussion, on situations that he refers to as representing "money on the table". While recognizing the possible political constraints that might limit the possibility to act, Shaviro is of the opinion that such constraints should not prevent an action where an action is warranted.[744]

Shaviro's important contribution is recognizing that tax policy decisions are not made in isolation and that there is a relation between US policy decisions and foreign countries' policy decisions, each affecting the other.[745] Thus, if the US chooses to react unilaterally, it should also take into account the possibility of other countries' reaction to the US initial reaction and whether by reacting in a particular way we are not contradicting other countries' policies.[746]

Shaviro supports a multilateral reaction to eliminate ITA, which would lead to a better division of the revenues collected from the denial of ITA among the different countries.[747] The important point Shaviro wishes to put across is the importance of looking beyond the point that other countries' tax laws are not the business of the US, as such laws clearly have an impact on the US.[748]

Ring proposes applying a balancing test to evaluate the competing different policies to decide in any given case whether intervention to prevent ITA is warranted and how such intervention should take place. The result achieved would probably be a compromise, neither full acceptable of ITA or full rejection of ITA.[749]

The result of applying this test may vary as policy goals or other features of the system change. As such, it is not a static test. Ring recognizes that ascertaining the policy goals of a country is an important step and might not be a straightforward process with one possible solution because sometimes tax policy is uncertain or undergoing an existing debate.[750]

According to Ring, the application of the test should provide a comprehensive consideration of ITA and to the creation of a sophisticated mechanism to fully understand the ITA problem and to craft the responses to it.[751] She recognizes the existence of two parallel paths, the national perspective and the international perspective and realizes that the outcome of

[744] *Ibid* at 326-327.
[745] See also Graetz (2001) above.
[746] Shaviro (2003) at 326. This observation was famously articulated by Kingson (Kingson (1981)).
[747] Shaviro (2003).
[748] *Ibid*, at 329.
[749] Ring (2003) at 83-84.
[750] *Ibid* at 161.
[751] *Ibid* at 84.

applying the balancing test may differ according to the path chosen, identifies the possible inconsistencies and achieves an outcome that would respond adequately to the competing goals of the national tax system as well as the "international tax system."

Ring recognizes that a national perspective emphasizes competition whereas an international perspective emphasizes cooperation and concludes that at the end neither approach supports national or international interests because "*neither nationalism nor globalization constitute a defensible, definable goal.*"[752] The real question is whose interest is to be taken into account in making tax policy decisions and what outcome serves that interest. In tax matters, Ring concludes that countries are the leading players.[753]

In her discussion, Ring focuses on only six different policies in the consideration of the ITA question. These are: efficiency, equity, political accountability, revenue effects, administrability, sovereignty and diversity.[754] For that purpose, equity includes both the tension between labor and capital that is discussed above[755] and the perception of tax abuse while political accountability refers to a situation whereby voters believe a certain tax regime is enacted but due to the lack of transparency in the tax rules are unable to identify that the effective tax regime is quite different to other taxpayers.[756]

According to Ring, a decision on part of countries not to intervene would be fairly unambiguous and would allow considerations of sovereignty, administrability and diversity to overcome considerations of equity and efficiency. A better way, according to Ring, would be to develop a method of evaluating the competing claims.[757] She takes the position that even those who oppose intervention do not disagree with the violation of efficiency and equity. Thus, the conflict takes place over the evaluation of the cost of intervention, a cost that can be divided into two broad categories, administrability and the risk to the systematic values of sovereignty and diversity.[758]

Ring's analysis is beneficial because it is based on the premise that there are competing policy considerations that should be balanced and that the decision in made for each type of ITA separately. Thus, a decision with respect to ITA resulting from cross-border leasing might be different from a decision with respect to ITA resulting from HFIs. In addition, Ring

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752 Ring (2003) at 84-85.
753 *Ibid,* at 85.
754 *Ibid,* at 135.
755 See pp. 32-34 above.
756 Ring (2003) at 123.
757 *Ibid,* at 134.
758 *Ibid,* at 124-125.

recognizes the tension between national and international efficiency and the possibility for different outcomes.

Unfortunately, she does not include in her discussion the possible application of other considerations, for example political considerations, foreign policy considerations, and competitiveness, considerations that can explain some of the policy decisions taken by countries. Furthermore, she does not relate to the domestic treatment of cross-border transactions in general quite apart from ITA. In addition, she appears to presuppose that ITA is bad and that the only question to be asked is whether intervention is warranted or not.

Edgar, looking at ITA alongside tax competition,[759] suggests focusing on the character of substitutability of taxing jurisdictions and transactional forms as providing a defensible basis for a limited range of ITA that is an appropriate target for policy response.

He analyzes existing literature on ITA and proposes three reasons why ITA should be responded to, whether or not there is a single tax principle or an international tax regime. First, those supporting benign treatment ITA assume that domestic classification decisions have some sort of an independent normative significance, although this does not exists in practice and many of the pervasive boundaries in tax law consist of a high degree of arbitrariness. This lack of normative content lead to arbitrary decisions in line drawing which are also very much the response to tax avoidance transactions involving situations of perfect or nearly perfect substitutability.

Second, even in the existence of some normative content for classification decisions, there is an assumption that the same decisions made in the domestic context should apply also in the cross-border context. According to Edgar, it is not clear whether decisions made in the domestic context should also apply in the cross-border context with respect to division of the tax base.

Third, supporters of benign characterization of ITA ignore the policy issues presented by ITA as a subset of the broader category of tax avoidance. ITA, according to Edgar, has the same policy stakes as domestic tax avoidance and although there are distinctions between the two, none of these distinctions has any important policy relevance. The central feature in both is the existence of lower-tax substitutes for transactions that would otherwise be subject to higher taxation. These transactions involve transaction costs, revenue loss and possible

[759] Edgar (2003).

efficiency loss that varies depending on the degree of substitutability of the low-tax transaction.

Thus, cases of perfect or nearly perfect substitutability present the clearest case for response to ITA, the challenge being where to draw the line in case of nearly perfect substitutability and how to identify those imperfect substitutes that should be included within the group of transactions to which a policy response is desired.

Examining both HFI and cross-border leasing, he focuses on those situations where there is perfect or near perfect substitutability between a transaction that is subject to high tax burden and one that is subject to lower tax burden. Edgar recognizes two types of substitutability, transaction substitution and jurisdiction substitution. The common feature of both types is that ITA enables taxpayers to achieve an overall better tax treatment while maintaining all or almost all of the non-tax features of the original transaction. In the former this is achieved by engaging in a transaction that is structured differently, for example, HFIs while in the latter the result is achieved through structuring the same transaction with an alternative jurisdiction, for example, a cross-border leasing with a lessor in country X as opposed to a lessor in country Y which preserves the non-tax features while achieving better tax treatment, the double-dip.

He distinguishes between the two cases and proposes a different approach to each type. Edgar regards cross-border leasing (and in particular the depreciation deductions element) as a form of tax expenditure, even though the determination of the entitlement to the expenditure may involve an element of arbitrariness. HFIs, on the other hand, contain no element of tax expenditure and are purely an arbitrary decision of the tax system regarding the taxation of the instrument. For that reason, Edgar approaches the two types of ITA differently because tax expenditures, being a spending program through the tax system should be assessed on the basis of standard budgetary criteria as opposed to technical tax policy criteria.[760] In other words, there is a clear policy objective to be achieved that is implemented through the use of technical rules. Thus, it appears that Edgar would regard ITA involving HFIs as being more objectible than ITA using cross-border leasing as long as the latter satisfies the underlying purpose of the expenditure.

I agree with Edgar's distinction of the two types of ITA. In my approach, which is described below,[761] I first address the specific rationale behind the specific tax provision that is the

[760] Edgar (2003) at 164.
[761] See p. 220 below.

subject of the ITA and only then move to discuss the effects of ITA on the tax policy at the country level and to what extent ITA conforms with this policy. Thus, in analyzing ITA of HFIs, the first part is generally irrelevant due to the arbitrary and technical nature of the distinction. This cannot be said of ITA in cross-border leasing where it is important first to determine whether the depreciation granted and the additional benefit of ITA conform with the specific rationale behind the decision to grant depreciation deductions in the first place.

Examining the two case studies and the preceding discussion, it is possible to put forward the following points:

First, tax policy decisions are conducted at the country level with an outlook of maximizing both national and international welfare as long as there is no contradiction between the two. In general, if the inter-nation distribution is not a concern and the system is a competitive system, then following the self-interests of the participants should lead to Pareto-efficiency.

According to the first theorem of welfare economics, competition leads to Pareto-efficiency. This, however, does not tell us anything about the other values of the Pareto-efficient outcome. Whether or not this point of Pareto-efficiency is also desirable is a question of distribution and different countries may have different views on how this should take place.

ITA has the effect of altering the distribution at the international level by providing preference to certain types of activities, to certain types of transactions and to certain types of taxpayers over others. To that extent, countries may attempt to act according to whether they perceive the ITA as improving or deteriorating their position.

Even acting in its national interest a country would try to predict the reaction of other countries to its possible decisions and act accordingly. Awareness should exist, however, to the possible understanding by other countries on one country's reaction to ITA. Some countries might perceive intervention as a signaling for cooperation while others might look at it as an aggressive act meant to secure revenues for the intervening country.[762]

The situation is less clear with respect to equity where it would be necessary to draw a line both to define the comparable taxpayer and to determine similar transactions and whether a given situation is similar enough to receive similar treatment.

762 Compare Shaviro (2002) with Kane (2004).

For example, a cross-border leasing transaction, with respect to which ITA is denied. Thus, a double-dip is disallowed and the taxpayer is not able to claim depreciation deductions with respect to an equipment another taxpayer is able to claim depreciation for.

Given that the benefit in double-dip leasing is not the second set of deductions but rather the accelerated pace in which the other party is able to claim them as opposed to rental deductions,[763] should a rule covering double-dip leasing also cover cross-border transactions where the other party is not able to claim deprecation but is able either to accelerate the rental deductions or to defer the income on the lease?

At the same time, as it is further mentioned below, other relevant considerations might influence the country's ability to act. These include both domestic and international restraints on the ability to act.

Second, ITA is a question to be determined based on the specific case and not an "all or nothing" question. While there are some situations where ITA should be prevented, there are others where it should be allowed.

For example, cross-border leasing and HFIs represent two completely different situations that necessitate a different approach by the relevant countries. HFIs are classified based on an arbitrary decision that is based on a problematic distinction between debt and equity and which takes place in each country depending partly on the legal environment in that country and on the response to domestic tax planning which lead different countries to base the distinction on different criteria, not necessarily correlating with the criteria or the line-drawing used by other countries.

Cross-border leasing, or leasing in general, forms part of an expenditure program that is designed to grant certain benefits to taxpayers and to promote the acquisition of assets for use in business. Unlike the situation with HFIs, here there is a solid policy reason behind the decision to grant benefits to some taxpayers and not to others, and, while the decision in part may involve some element of arbitrariness, it requires us to ask whether the specific taxpayer or the specific transaction is included in the type of transactions that were meant to be covered by the expenditure legislation. The difference between countries can thus result from two main sources. One point is the difference in the nature of transactions or taxpayers that are meant to be covered by the expenditure. The other point is that the differences in the

[763] Ring (2003) at 174.

approach each country is adopting towards identifying the covered taxpayers or to analyzing the relevant transactions.

This point can also gives rise to an alternative analysis that also supports the general view that each case should be analyzed separately. Thus, for example, ITA with HFIs can be seen as less objected to ITA with cross-border leasing. Because ITA with HFIs operates with respect to the different arbitrary line drawing of the two countries involved it cannot lead to the frustration of a policy on this part of one or two of the countries involved, mainly because there is no such policy to be violated in the first place. Cross-border leasing, on the other hand, is based on depreciation deductions which follow, in each country, a separate expenditure policy that each of the countries involved sought to execute through its tax system. ITA has the effect of altering such policy by giving preference to one type of property over others in a way that, even if not clearly objected to by the country involved, cannot be said to represent its intent in formulating the expenditure policy in the first place. Thus, although ITA does not contradict the general idea behind the expenditure policy (for example, to promote investment in business assets), it may well violate the details of the policy and its approach to the treatment of specific assets (for example, by allowing one type of property that can be used for ITA more accelerated depreciation vis-à-vis other properties that cannot be used for ITA even though the intent of the expenditure policy was to treat all assets alike).

The answer which analysis should be preferred depends also on the analysis of the country's international tax policy in general. I prefer the first approach above mainly because of the difficulty and uncertainty of ascertaining the true intent of the legislation. For that reason, I believe that the analysis should focus on whether there is a clear violation of the rationale (for example, by granting depreciation deductions to leases that are not meant to be covered by the depreciation scheme).[764] Whether or not the existence of a rationale supports ITA depends on whether the ITA violates the purpose of the legislation and its rationale. The rationale should be used as a reason for intervention only to the extent that it is frustrated by the ITA.[765]

Third, although prima facie it appears that there are clear inconsistencies between the different systems, each taking a completely different approach (for example, one system using an economic substance approach while the other relies completely on the legal form), in practice these differences are much more subtle and restricted. For example, in the

[764] See also Ring (2003) at 148.
[765] *Ibid.*

classification of a transaction as a true lease for tax purposes in the US, although the general theme is to look at the economic substance of the transaction to determine its appropriate classification, this general theme is restricted by three very important restrictions that may require the taxpayer to follow the form of the transaction despite a contradicting economic substance.

As a result, although, as it is further developed in the next point, the distinction in the treatment of the transaction in different countries is to a large extent the result of each system adopting its own approach which is developed in that country independently, responding to domestic challenges and not necessarily cross-border challenges, the differences that remain, are much more subtle and delicate and using them for the advantage of the taxpayer requires sophistication that is not readily available to all. As such, this may give rise to equity considerations.[766]

Fourth, despite the differences, both case studies represent situations where a distinction is drawn for tax purposes between a situation that is treated one way and another situation that is treated in another way. This distinction is to a large extent focused domestically and is based on the development of domestic law responding to domestic challenges and not necessarily cross-border challenges, where the legislation and the courts interpret and change existing law by responding to domestic tax planning.[767]

Thus, not only tax policy decisions that are made at the country level but line drawing determining the tax treatment of a particular transaction is to a large extent a practice influenced by domestic reaction to domestic tax planning which challenges the line drawing at the national level. As a result, the approach adopted by each country is a relatively isolated approach.

Moreover, when benefits are denied at the cross-border level, they are often denied because of the application of limitations that apply with respect to all cross-border transactions and not necessarily those involving ITA.

This leads us to the fifth point. In both countries the legislation includes specific provisions that are designed to limit the benefits to domestic transactions or to domestic taxpayers or that impose greater restrictions where the transaction in question is a cross-border transaction. To a large extent, these provisions apply to all cross-border transactions and not

[766] See also Makhlouf (2001).
[767] For example, MIPS in the US with respect to the classification of instruments as either debt or equity.

specifically to ITA, making the question of the treatment in the other country an irrelevant consideration.[768] Not only that. A successful ITA will normally exist while satisfying the requirements of the special legislations adopted with respect to cross-border transactions.

For example, in the case of cross-border leasing, export leasing is in general perceived by both countries as undesirable and both countries try to limit the availability of the depreciation benefits to such transactions to make them less beneficial and persuade taxpayers not to engage in them. This is not an objection to ITA but rather an objection to a certain type of cross-border transaction whether or not the benefit is duplicated in the other country.

The question is what can be understood from this point. Assuming the existence of ITA is known (i.e. there is no information problem) there are at least three different explanations that can be put forward. First, that existing legislation does not cover ITA because of problems in the design of the existing provisions and their scope. Second, ITA is left untouched because there is a difficulty in dealing with ITA through legislation and a danger for discriminatory or circular provisions. Third, ITA is left untouched because despite the end result (the benefit) the transaction is within the scope of transactions that should be allowed to benefit from the provisions of the legislation. As such, there is no reason to object. In the context of cross-border leasing – a transaction that should be entitled to receive the benefits of accelerated depreciation.

Sixth, as noted above, in determining tax policy, it is necessary to take into account the effect of these decisions on other countries as well as the effect tax policy decisions by other countries might have on the country in question. In particular, intervention in cases of ITA can be understood by other countries to be either an act of aggressiveness or a signaling against allowing ITA.[769] In addition, outside the realm of efficiency, foreign relations represent an important element in policymaking and should also be taken into account when the ITA in question is the type referred to by Edgar as being "jurisdiction substitutability".

Seventh, while attention should be given to the interaction between different countries and their policy decisions, similar attention should also be given domestically, both to the effect political decisions have on tax policy and to the feasibility of certain policy decisions given

[768] There are, however, some exceptions to this general rule of specific situations in which specific targeted legislation was applied to prevent ITA although there are also other situations where domestic practice accepted the existence of ITA.
[769] Compare Shaviro (2002) and Kane (2004).

the political element and to the effect decision regarding international tax policy might have on the domestic market and the relations between different types of domestic taxpayers.

Eighth, the lack of knowledge regarding the existence of transactions that are treated inconsistently presents a practical challenge to tax authorities. This can explain some of the hostility that exists with respect to some types of ITA which involve inconsistent treatment that results from applying similar principles in these situations, unlike situations where the inconsistency results from the application of different principles, there is a danger that the inconsistency is the result of inconsistent presentation of the factual situations as opposed to inconsistency from the application of the law to the same set of facts in the two countries. This danger leads to certain hostility towards some types of inconsistencies, which is inapplicable to ITA as defined in this work and should not be confused with ITA.

Based on the above-mentioned discussion, I propose the following analysis to determine whether a country should intervene in an ITA situation.

The starting point in the analysis is with the premise that policy determination is conducted at the country level. At the same time we need to take into account both the effect such determination might have on other countries' tax policy as well as the effect other countries' tax policy might have on tax policy decision in our country.

The first step is to discover the rationale behind the benefit granted to the taxpayer / transaction in the transaction that is subject to the ITA and to determine whether ITA violates this rationale. For example, in the case of cross-border leasing, it is necessary to discover the rationale behind the grant of depreciation deductions and to determine whether and to what extent (if at all) the grant of deductions in another country through an ITA violates such rationale. In the absence of such rationale, like for example with respect to HFIs, the analysis starts with the second step.

The second step is to analyze, independent of ITA, the appropriate international tax policy for the country. For example, in the case of HFIs, it is necessary to determine what is the appropriate policy of the country with respect to inbound direct and portfolio foreign investment as well as with respect to direct and portfolio outbound investment. The main challenge at this stage is to be able to determine whether a perceived tax policy is indeed the appropriate tax policy for that country with respect to the relevant type of transaction.

The last step is to apply the specific ITA and to determine whether intervention is warranted based on a determination in one of the above-mentioned steps. Even if an intervention is warranted based on the country's tax policy choices, it is still necessary to determine that the intervention as well as the manner in which it is supposed to take place fits with the rationale that is discussed under the first step, with the overall structure of the legislation in that area and with the international tax policy of the country.

In this step, it is necessary to investigate the effect an intervention (or lack thereof) might have both internationally and domestically and to attempt to analyze possible responses of other countries to such reactions. In the process, both foreign policy and domestic political considerations should be taken into account.

Applying to the case studies

In the next part I apply the outcome of the above-mentioned discussion to the two case studies that were introduced and discussed above. The application at this stage is at the policy level questioning what should be the policy of a country towards ITA in a given situation. For that purpose, it is necessary to identify the competing policies and to apply them to the case study. To do that in a clear and illustrative way, I conduct the analysis by reference to examples.

HFIs

At the policy level, it is necessary to distinguish among three different categories, direct investments where the target is still undecided, direct investments where the target is already determined and other investments. Each of these categories is further divided into two, inbound transaction and outbound transactions.

Unlike the situation with cross-border leasing, here the transactions are often purely financial transactions. Some of these transactions, especially those falling into the second category are transactions with a very strong tax influence.

An important difference between cross-border leasing and HFI is the source for the ITA. Unlike cross-border leasing, the ITA in HFI is based on an arbitrary distinction between the treatment of debt and equity for tax purposes, an arbitrary distinction that each jurisdiction approaches differently. Unlike cross-border leasing, there is no clear policy goal that each jurisdiction intends to achieve. Thus, whereas in the context of cross-border leasing I also examine the compatibility of ITA with the underlying policy of the legislation, no such examination is conducted in the context of HFIs. The only requirement in addition to the analysis at the country level is that the legislation would be consistent in its application and would not violate, to the extent possible, the principle of equity.

Another difference worth noting is the relatively wider application of these types of transactions. Unlike cross-border leasing transactions which are generally open only to taxpayers who are either considering to lease an equipment that is covered by these types of transactions or are in the business of manufacturing such equipment, HFI are more readily available to a wider category of taxpayers who are able to use this method of finance even if they are not engaged in cross-border transactions as part of their business. For example, under the third category discussed below,[770] purely domestic taxpayers may use the advantages of ITA to raise cheaper finance. Thus, cross-border leasing generally is more limited in application, applies only with respect to a selected industry sector and usually has a corresponding business purpose.

On one hand, the more limited scope of cross-border leasing and its selective application gives the appearance that risks like revenue loss are more manageable and can be limited by identifying a very selected group of transactions that qualify for ITA. On the other hand, the narrower application of double-dip leasing within the already narrow category of cross-border leasing may lead to questions of efficiency and equity because the treatment of leasing becomes more advantageous vis-à-vis other forms of finance and because the benefits of leasing are only available to a limited group of taxpayers.

Thus, while the more limited application might reduce some of the objection to ITA on one hand, the same feature may make the case for intervention more compelling on the other hand.

Category 1

The first category deals with direct investments in situations where the location of the investment is still undetermined.

I use the following example to illustrate the application of the competing arguments: BIGCO, a country X resident company wishes to expand its international operations. After considering a large number of countries, BIGCO has finally limited its choice to one of two

[770] See pp. 232-235 below.

possibilities, country Y and country Z. I assume that both countries are relatively similar in their non-tax attributes and that both countries have a relatively similar rate of corporate tax. One of the important considerations in the decision is the ability to finance the operation of the new company that will engage in sales and marketing of BIGCO's products in the region.

The tax laws of country X and country Y create a situation whereby it is possible for a HFI to be treated inconsistently under the tax laws of both countries, resulting in an ITA. Such ITA does not exist between country X and country Z.

Country Y perspective

Prima facie, there is a revenue loss as a result of the ITA because of the combination of an interest deduction in one country (country Y) without an income inclusion in the other country (country X). In addition, past studies have demonstrated that usually tax incentives targeted at attracting investments into a country do not prove to be beneficial overall, the cost being greater than the benefit.[771] However, it appears that if country Y has thin capitalization and transfer pricing legislation in place, then ITA should not result in further revenue loss.[772] Having thin capitalization and transfer pricing legislation in place would commonly be the situation regardless of the existence of ITA but rather to prevent base erosion due to highly leveraged finance by related parties.[773]

The combination of both provisions would limit the amount of debt and of interest expenses that a country Y corporation is able to claim. From a country Y perspective, there is no difference whether the instrument that is characterized as debt there is classified as equity elsewhere. As a debt instrument giving rise to interest payments which can be deducted, such instrument is subject to all the limitations that are usually imposed by country Y's tax law. In general, debt financing is preferred to equity finance also in cross-border financing. As a result, due to above-mentioned limitations, country Y should be indifferent whether the instrument which is classified as a debt instrument has a different classification elsewhere.

One caveat to this argument is the possibility of a wider revenue loss. That is, revenue loss that does not result directly from the HFIs but indirectly from the reaction to the existence of the ITA. First, the suggestion above is made on the premise that the country has thin capitalization and transfer pricing provisions that would cover also guaranteed loans by third parties. To the extent that the existing legislation does not include such rules, then it might

[771] Avi-Yonah (2000) at 1643.
[772] In such case, the revenue loss should be suffered by the other country, country X. See below (p. 228).
[773] But cf. C-324/00 *Lankhorst-Hohorst* with respect to the UK.

be possible to structure the investment through a third party. This would indirectly increase the leverage of the domestic company and is likely to result in revenue loss. For example, investments into a country, which like the UK does not have provisions dealing with third party guaranteed loans, can be structured through unrelated third parties, lead to increased leverage of domestic corporations, an increase which is encouraged by the availability of ITA and which is not covered by the thin capitalization and transfer pricing provisions.

Second, even without the possibility of guaranteed third party loans, it is possible that an increase in investments by taxpayers resident in country X (which are able to enjoy the ITA) will result in a move of investors from other countries, for example, country M, to invest in other countries instead of country Y.

Third, the application of EC law is likely to limit the ability of MS to treat non-residents disfavorably vis-à-vis domestic taxpayers to the extent the former are nationals of a MS. This may limit significantly the ability of MS to have effective legislation in place to prevent the base erosion whether through direct investment or through indirect investment from another MS. Moreover, the treatment of the other party to the ITA is not relevant and cannot be used to justify the discriminatory measures by the MS.[774] Therefore, a distinction should probably be drawn between the UK and the US. The UK, despite its need for foreign investment and the increasing competition from other MS, is unlikely to have sufficient legislation to ensure that the revenue loss is not borne by it.

Revenue loss being an important consideration, the UK is likely to attempt to prevent such ITA, especially if it exists with respect to HFIs which are in general more readily accessible to taxpayers. Unfortunately, EC law might significantly limit the UK's ability to counteract. Measures like those adopted in 1992 with respect to equity notes are likely not to survive a challenge at the ECJ. This is likely to limit the UK's ability to respond and political restraints are likely to prevent the UK from responding selectively to some countries.[775] Moreover, EC law (and especially the relatively wider freedom of movement of capital) is likely open the ITA to be accessed also by residents of third countries, thus potentially increasing revenue loss problem. The open options to the UK appear to be: (1) not to react (2) react by a complete change of the law[776] (3) react by applying international measures also to domestic

[774] C-294/97 *Eurowings* and the discussion above on EC law and its impact of UK tax policy.
[775] Equity notes – above (pp. 141-144). European Union – above (pp. 81-95).
[776] Discussed below in the context of cross-border leasing.

transactions, and (4) react through the use of tax treaties with selected countries with which the ITA takes place.[777] However, such measures would have to comply with EC law.[778]

Even outside EC law context, the availability of the bilateral approach to ITA might solve other concerns that may affect the decision on ITA in a unilateral decision, for example, foreign policy and the reaction by other countries to a unilateral act on the part of one country. Yet, the availability of the bilateral approach depends on the existence of common understanding between the two countries with respect to the appropriate approach to be taken in the specific situation.[779]

Fourth, the validity of the no revenue loss argument depends to a large extent on the state of the capital market in the country Y and the ability of financial institutions in that country to offer, through repackaging, the benefit of ITA to taxpayers that would not be able to benefit from the ITA directly. This possibility, however, appears to be more relevant in the context of category 3 below where the threshold of the investment is lower (not being a direct investment).[780]

Even if from a pure revenue loss perspective country Y might appear to be an indifferent party, because of its desire attract foreign investment into its territory, it is not completely indifferent. Eventually, it might gain more revenues at the expense of other countries paying for the incentive. This might change in category 2, where country Y is no longer concerned about the loss of the foreign investment and might have its own reasons for being willing to give up the free benefit conferred by the ITA in exchange for something else.

Another consideration is equity. The question is to what extent a domestic corporation with a foreign investor and a domestic corporation with a domestic investor are in the same situation or in a different situation. To the extent that they are in a similar situation, equity would require similar tax burden and similar treatment. Conversely, to the extent one is economically better off (before tax), equity would require their treatment to differ.

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777 See for example, 2001 US-UK tax treaty.

778 See generally Craig (2003) in the context of the 2001 US-UK tax treaty.

779 An obstacle might exist if, for example the country of source, like country Y in our example, does not have a reason to do so because it does not suffer a revenue loss.
As Edgar notes, the 2001 US-UK tax treaty is a good example of a bilateral approach where two countries agree on the treatment of a specific type of transaction. To the extent the ITA exists with other countries as well, a unilateral approach through a tax treaty might result in a violation of equity and efficiency. Compare the approach taken by the US and UK in 1986 (IRC §1503(d) and TA 1988 s.404, respectively) and the approach taken in 2001 (2001 US-UK tax treaty).

780 See pp. 232-235 below.

From a competition perspective, it is necessary to balance the potential desire on part of the country itself to be regarded as more competitive and attractive (due to the availability of ITA) and the desire of domestic corporations to preserve their competitiveness vis-à-vis foreign corporations investing in country Y.[781] To a large extent, the choice depends on the identity of both the country and those domestic taxpayers that consider themselves as being disadvantaged by the existence of the ITA.

At the country level, the advantage of ITA over other more conventional methods of tax incentives is the lack of clear action to create the benefit, an act that might attract criticism and counter-actions from other countries. ITA created as a result of differences in the general structure of the tax systems in the two countries might be perceived as less controversial when compared with specific intentional introduction of tax incentive measures.[782]

Nonetheless, the importance of competitiveness at the country level depends to a large extent on the identity of the country involved. A country like the US should be less concerned as to whether or not it is competitive enough for direct investment by foreign corporations mainly because of its vast market and the lack of comparable competitors.[783] This goes well with a powerful and important local industry that is eager to maintain a level playing field by preventing ITA for inbound investments.[784]

The UK, on the other hand, which is dependent to a large extent on foreign investment including foreign direct investments but does not have a natural market that would attract such investments (like the US), might find itself in a different position, especially in light of the EU which is supposed to create an internal market without any borders and limitations making the competition among MS harsher with respect to attracting foreign investments from outside the EU.[785]

The position of the country with respect to attracting foreign investment can serve as an important consideration in the final decision, especially if the cost of financing for the incentive, which is usually the object of existing criticism on the desirability of tax incentives, is borne fully or partially by other countries.[786]

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[781] For example, country X corporations who will be entitled to the benefits of the ITA and thus enjoy a lower cost of finance with respect to their operations in country Y.
[782] This is especially due to an important difference between ITA and tax incentives. Whereas the latter are often the result of a positive act of legislation, the former are not. With ITA to have the incentive, a country merely has to retain existing law. A task that is likely to prove much easier than the alternative.
[783] In that sense, the US is closer to being a "captive market".
[784] See for example, IRC §894(c) and the regulations that followed.
[785] Refer to our preceding discussion above.
[786] Outside the narrow scope of ITA, it might be perceived as sending a negative signal to potential investors.

At the taxpayers' level, an important question is which industry is most affected by the existence of ITA. This would depend to a large extent on the identity of the possible beneficiaries from the ITA, those taxpayers residents of country X that would be able to operate in country Y with lower costs of finance. The more powerful the domestic industry is, the more likely it is for an intervention to take place.[787] A good recent example is the legislation dealing with the US domestic reverse hybrid entities and the prevention of ITA opportunities there due to a legislation that was initiated following pressure from domestic taxpayers complaining about the competitive advantages of their Canadian competitors who were able to benefit from the ITA that existed prior to the legislation.[788]

Another option is for country Y to use the ITA and its decision to prevent it as a signal to other countries regarding its intent to disallow ITA.[789] At the same time, it is necessary to take into account the price of the signaling (especially if it is discovered that there is no revenue loss in which case it is paid for in other's people money). The price can be a preference by foreign corporations to invest elsewhere. In addition, unless the situation is properly addressed, an intervention to prevent ITA might be perceived as a negative signal to the foreign country (country X in our example), a measure that is designed to reduce the competitiveness of country X's taxpayers operating in country Y or an aggressive attempt on part of country Y to benefit from all or part of the funds saved by the prevention of the ITA at the expense of country X.

Thus, the more aggressive a country is with respect to its treatment of inbound investment, the more limited ITA is and the more able such country is to allow ITA to exist as an incentive paid by other tax systems.[790] In addition to possible arguments of efficiency and equity, potential objections for allowing ITA to exist can be found either in the form of political objections or of request from other countries that suffer from the existence of the ITA to collaborate and deny together the ITA. On the other hand, a country that does not have aggressive inbound approach is more likely to suffer from the ITA and to find it necessary to intervene and prevent the ITA from taking place. In this respect EC law has an

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[787] In HFIs because of the general applicability to many different industries, it is quite possible that the reaction to ITA would be cross-industry. For example, having a wider group of domestic businesses supporting intervention where their interests would otherwise suffer.

[788] See generally, Sheppard (2004).

[789] The signaling idea is promoted by Kane (2004) but contrast Shaviro (2002).

[790] For example, in the US, the existence of the anti-conduit legislation helps to close some of the opportunities for ITA through the use of intermediaries. Although these ITA situations are generally objected to on the ground of artificiality, the existence of provisions like the anti-conduit provisions allows the country the comfort with respect to the decision whether to respond to ITA. This is because the existence of these provisions is likely to prevent ITA that includes an element of artificiality, limiting the opportunities for ITA and thus making it more or less manageable.

important influence as it causes MS to remove some of the protective measures, thus making them more vulnerable to ITA. As discussed above,[791] such countries often do not have the ability to react. In the context of the EU, this is mainly due to the application of EC law which would tend to limit any measures adopted to the extent such measures are in violation of EC law. These EC law limitations, which apply regardless of ITA, affect MS' ability to adopt measures to prevent ITA. Below,[792] in the context of cross-border leasing, I discuss one of the options that countries have to overcome such limitations.

Country X perspective

Here as well, it is necessary to examine whether the revenue loss is borne by country X. The revenue loss can also be the result of a preference on the part of domestic companies to form or acquire foreign subsidiaries by using a combination of equity and HFIs both of which are relieved from taxation in country X. To the extent the availability of ITA results in an increase in the percentage of equity finance (including both pure equity and HFIs), the revenue loss should be limited to the amount of tax on interest income that is no longer received and taxed and to the amount of underlying foreign tax credit that is granted to the taxpayers as a result of the ITA.[793]

The revenue loss is also dependent on the nature and identity of the country into which the ITA is structured. ITA with a country with which country X has substantial trade relations might lead to high revenue loss due to the volume of cross-border investment and the general nature of HFIs ITA. On the other hand, an ITA with a country that does not have developed trade relations with country X might not give rise to significant revenue loss concerns from country X's perspective, sufficient to warrant intervention[794] [795]

In addition to the revenue loss, two competing interests from country X's perspective are domestic competition and the need to preserve neutrality in the determination between

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[791] See pp. 87-93 above.
[792] See pp. 235-242 below.
[793] Since both the US and the UK are foreign tax credit countries, the assumption is that this method is used by the country of residence. If, however, the exemption method is used instead, then the possibilities for structuring HFIs and especially under category 3 are much wider.
[794] Thus, for example, ITA was denied in the UK in 1986 (dual resident companies), in 1992 (equity notes) and in 2001 (Repo transactions) when the other country was the US. ITA was also denied by the US in 1986 (dual resident companies) when the other country was the UK and in 1997 and 2002 (hybrid entities) when the other country was Canada. Whether the country intervening is the country of source or the country of residence in each case is less relevant as long as there appears to be a revenue loss. Once a revenue loss appears to exist, the identity of the other country becomes relevant. The identity of the other country is also relevant in the competitiveness and political considerations that are mentioned below.
[795] To the extent that there is an attempt to use the ITA with respect to transactions between the two countries and a third country, such attempts should be dealt with by general anti-avoidance legislation as the objection is not the ITA but the artificiality that is involved when a third country enters the picture.

foreign and domestic investments on one hand and international competition on the other hand.

Regarding the first interest, the need to preserve neutrality, its scope and application depends to a large extent on the international tax policy of the country in question. For example, both the US and the UK follow CEN but only in a limited way. The US, for example, based its approach on a more than forty years old compromise between complete CEN on one hand and competitiveness supporting deferral of tax on foreign source income on the other hand. Being a political compromise, it is hard, if not impossible, to clearly determine where the compromise lies. Arguably, so long as the ITA supports the conduct of active business abroad, then this should be covered by the competitiveness part of the compromise which would allow ITA. This, however, is not completely clear.

Thus, in the US for example, a determination of the scope of this interest would require a prior determination of a wider issue, US tax policy for outbound investments and in particular, the balance between CEN and equity on one hand and competitiveness on the other hand. This would require first the ascertainment of the true logic behind Subpart F to determine whether ITA violates the rationale behind the legislation or supports the compromise reached in 1962.[796]

This determination of the true scope of the legislation has a strong element of competitiveness to it. On one hand, allowing the ITA to continue would allow domestic corporations that operate abroad in countries with which ITA is possible to enjoy lower taxation on their investment and as a result, a competitive advantage. The two questions that should be considered are whether this constitutes a neutral competitiveness or a disguised form of a subsidy and whether country X should promote the competitiveness of its resident corporations as part of its tax policy.[797]

Intervention might be less objective if the competitiveness argument loses its strength, whether because of a different legislative system that is less influenced by such arguments from the industry or because of a weaker link between the specific ITA and the competitiveness of the taxpayers asserting this argument.

[796] See for example the exchange between David Hariton and Reuven Avi-Yonah on the treatment of income from manufacturing tax haven companies and the logic of Subpart F – Avi-Yonah (1998a) (1998b) and Hariton (1998).

[797] The different aspects of these questions are considered as part of the general discussion of competitiveness, above (pp.44-46).

On the other hand, allowing ITA to exist is likely to alter the competition between resident corporations that operate both domestically and abroad and those that only operate domestically.[798] The latter, unable to enjoy the benefits ITA might find themselves in a competitive disadvantage vis-à-vis the former. To the extent the resident corporations that only operate domestically cannot alter their position, an additional consideration becomes relevant, equity.

An interesting distinction that was mentioned in the context of the competitiveness argument is the link between the ITA and the business of the taxpayer as a criterion for the strength of the competitiveness argument. Compare, for example, cross-border leasing when the argument is put forward by the lessor who also manufactures the equipment on one hand and ITA from a financial transaction unrelated to the taxpayer's core business, especially if it also involves some element of artificiality (repo transactions for example).

Prima facie, the first category appears to be more justifiable because the availability of ITA is connected directly with a legitimate transaction, the acquisition of a business asset, and appears not to contain abuse. The other type of ITA is a pure financial transaction that may or may not be related to another business activity. As a result, there is a risk that such transaction involves a certain degree of artificiality that is designed to obtain the tax benefit as the transaction's prime goal (as opposed to a situation where the tax benefits are ancillary to or correspond with a business activity). But this is not necessarily that clear.

The question is how to distinguish between similar and less similar transaction. That is, where to draw the line. Another consideration that has to be examined is the relation between this distinction and other policy considerations. For example, the different approach that is usually adopted with respect to inbound ITA on one hand and outbound ITA on the other hand.

For example, if on one hand, we have one taxpayer that enters into a cross-border leasing transaction that enjoys the benefits of ITA and on the other hand we have a taxpayer that acquires the same property but uses for this purpose funds he raises from third parties through the use of HFIs that also benefit from ITA (alternatively, he can raise the money by benefiting from ITA through a repo transaction). Should they be treated differently? Should the direction of the ITA make a difference? Equity considerations would appear to argue that

[798] For simplicity I refer to this group as including corporations that only operate domestically. In fact, to be accurate it is necessary to define this group as including corporations that operate both domestically and abroad but not in countries with which the benefits of ITA are available.

no such difference should take place to the extent the taxpayers are in a similar pre-tax position. The answer would depend on the policy priorities of the country in question. For example, countries like the US that appear to adopt a lenient approach with respect to outbound ITA alongside an aggressive approach to inbound ITA would find it difficult to maintain the distinction based on the business activity connection test.

Throughout the debate it is important not to overlook political considerations and the extent to which political pressure might alter the balance between the above-mentioned considerations and result in either intervention or non-intervention. On one hand, those corporations that benefit from the ITA would press for political support on the basis of maintaining their competitive advantages.

On the other hand, taxpayers that are likely to be disadvantaged by the ITA would press for political support to deny ITA benefits on the basis that ITA assists domestic corporations to operate abroad and would result in migration of workplaces outside the country.[799] I return to this issue in the context of cross-border leasing, below.[800]

Category 2

Unlike the first category, here the location of the investment is already determined and BIGCO has chosen to invest in country Y. After five years of operation, BIGCO would like to refinance its operations in country Y. Like in example above, the tax laws of countries X and Y make it possible to structure a HFI that would be inconsistently characterized in the two countries resulting in an ITA.

The question is whether to allow two taxpayers who are probably related (due to the investment that was already made) to enjoy a lower burden of taxation with respect to a transaction that but for the ITA would give rise to higher tax. Most of the different considerations mentioned above[801] in category 1 are valid for the discussion here. The important difference is from country Y's perspective and related to the fact that the destination of the investment is already determined. As a result, the danger of non-investment is reduced. Theoretically, country Y might wish to use this change and prevent the ITA thus raising its tax revenues.

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[799] Compare US corporations' reaction to Notice 98-11 (leading to Notice 98-35 and regulations that have yet to be published) on one hand and their support of the Treasury in enacting s.894(c) and the regulations thereunder on the other hand.
[800] See pp. 235-242 below.
[801] See pp. 222-231 above.

Under category 1 country Y has less incentive to react because a reaction might lead to foreign investments going elsewhere. This risk is reduced under category 2 but it still does not follow that country Y should intervene despite the arguments supporting such intervention, as discussed under category 1 above.[802]

If signaling is appealing to country Y, category 2 might represent the best situation to do so without a great risk of losing foreign investments as a result and while maintaining the potential risk of loss at a manageable level.

Thus, whereas country X's situation does not change from category 1 to category 2, country Y is now in a position of intervening and preventing the ITA. This is also consistent with a prior policy decision by the UK.[803]

An important objection to intervention is that such a decision would be hard to reconcile with a decision not to intervene under category 1, both in practice (how to make the distinction) and when regarded from an equity perspective. Thus, despite the different interaction of the competing considerations under category 1 and category 2, country Y will be required to reach the same decision in both cases. Consistency and possibly also equity considerations would require such an approach of non-intervention to be followed.[804]

Category 3

After successfully expanding its operations, BIGCO is interested in raising additional funds to finance to expand its operations to other regions. BIGCO is issuing HFIs that are characterized as debt in country X. In foreign jurisdictions, the character of the HFIs varies. In some jurisdictions the HFIs are treated as debt and in other jurisdictions, including country Y, the HFIs are treated as equity instruments.

In this category, the subject of the investment is mobile income that is more susceptible to the effect of taxation. In addition, being a mobile portfolio investment, it is relatively easy to move it from one location to another and locations usually do not confer any significant

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[802] See pp. 222-228 above.
[803] Legislation preventing ITA through the use of equity notes (1992).
[804] This does not mean that the analysis is not valuable and should not be conducted separately, at least at the stage of determining the desired policy. Although it appears that for considerations of consistency and possibly equity, similar policy has to be adopted for the two categories, a separate analysis of the two categories can provide us with information that would assist in making a better informed decision. For example, it can provide us with information on which of the two categories is more significant. This can assist in determining, in case of a conflict, whether to follow the decision made with respect to category 1 or the decision made with respect to category 2.

benefits apart from the tax and can be replaced with relative ease. As a result, the decision where and how to invest is much more influenced by the tax treatment of the investment and countries are more likely to carefully review legislative actions that can have the effect of altering investment patterns and are more likely to react to existing trends to improve their relative position.

Moreover, availability of ITA in these instances might allow domestic businesses to raise funds more cheaply and improve their competitiveness. This might have also some political element that can affect the decision.

Country X perspective

The transfer pricing and thin capitalization provisions that are relevant with respect to categories 1 and 2 above[805] are no longer applicable in this category. At the same time, due to the absence of special relations between the issuer and the holder, there is usually no need for such.

In order to benefit from the underlying foreign tax credit in country Y, the country Y resident has to invest a relatively significant amount (usually, the underlying foreign tax credit is available to shareholders holding 10% or more from the shares of the issuing company). This requirement would significantly limit the range and amount of potential taxpayers who might qualify and enjoy the ITA under this category.

Nonetheless, unlike the situation under categories 1 and 2 above,[806] here the country risks the possibility of a revenue loss as a result of the availability of a perfect or nearly perfect substitute that give rise to lower tax revenues.

Here, country X needs to examine the potential revenue loss on one hand and the potential benefit for its taxpayers with the availability of cheaper and more diverse finance which might allow them to become more competitive on the other hand.

While domestic taxpayers should in general be better off, this does not necessarily cover all domestic taxpayers. Some taxpayers are likely to be disadvantaged by the existence of the ITA. These taxpayers are likely to include small corporations that are unable to raise finance from foreign sources and do not have access to the market. In addition, a similar outcome

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[805] See pp. 228-232 above.
[806] See pp. 228-232 above.

might result with local financial institutions that might find the existence of ITA to disfavor them, as they would not be able to compete with the advantages created by the ITA. At the same time, they should have more funds to finance other corporations that are not able to raise funds abroad or that are in more difficult financial situations. Thus, arguably, ITA can have the effect of freeing capital to finance other taxpayers that are unable to enjoy the benefits of ITA because they are unable to raise funds from investors abroad either because they are too small or because they are not in a financial situation that allows this.[807]

This is an interesting point that might be subject to further empirical examination. That is, does ITA actually serve as improving the availability of funds in the market? If, for example, BIGCO is able to get better finance by raising money from foreign investors and as a result reduce its borrowing from domestic financial institutions who are then able to finance more local businesses including those that have no access to the international market, then it can be argued that ITA actually promotes the availability of funds in the market. Alternatively, the existence of ITA may result in capital leaving the country with the benefit of the ITA leading to an increase in the cost of capital. In this situation, ITA might not serve as improving the availability of funds in the market.

An important consideration against possible intervention is the lack of apparent abuse.[808] The transaction is conducted between unrelated parties and thus the presumption of arm's length and no abuse exists. Unlike the transactions in categories 1 and 2 above,[809] non-tax considerations may play an important role in the structure of the investment, including the rights granted by the instrument to the holders, the payments etc. in this environment, when the substitution is achieved through negotiation between two unrelated parties, there is a strong reason not to object.

Country Y perspective

Starting with neutrality and efficiency, the first task is to determine the policy of country Y. If, country Y follows a policy of neutrality with respect to outbound investments and in particular outbound portfolio investments, then ITA represents a violation of this policy as it creates an advantage for taxpayers to invest abroad. If, however, country Y does not follow

807 Alternatively, there might be able to create, through repackaging, an investment product that enjoys the benefits of the ITA and can be marketed to domestic taxpayers in country X. This outcome, if it takes place, is likely to result in more revenue loss to country X. Its availability depends, among other considerations, on the amount that is at stake (potential revenues and potential tax saving) and transaction costs.
808 Ring connects this concept with the concept of equity. See Ring (2003) at 122.
809 See pp. 222-232 above.

such policy, then it might be indifferent to the existence of ITA, at least from an efficiency and neutrality perspective.

From an equity perspective, it depends whether or not ITA is open to all taxpayers. Unlike under categories 1 and 2, the opportunity to invest abroad should be, theoretically at least, open to all taxpayers. Absent either high transaction costs or high minimum investment requirements,[810] the relevant objection is efficiency rather than equity.

Another potential argument favoring intervention is the potential revenue loss. Unlike under category 1 and 2, here the thin capitalization and transfer pricing rules do not apply and it is possible that more HFIs will be created replacing also some equity investments, increasing the amount of interest deductions in country Y while not decreasing the amount of foreign tax credit and especially underlying foreign tax credit in country X, thus resulting in revenue loss for both countries.

Cross-border Leasing

Assume that USCO, a US resident company is an airplane manufacturer. As part of its business, USCO enters into a leasing transaction with Easyair, a country X resident company that is interested in expanding its airplane fleet. In the process USCO compete against ZCO, a country Z resident company that is also an airplane manufacturer. As part of the leasing arrangement between USCO and Easyair, the parties manage to arrange the transaction through USCO's wholly owned foreign sales company resident in a low-tax jurisdiction. In addition, the transaction includes an option granted to Easyair to acquire the airplanes at the end of the lease period at FMV. The existence of this option does not alter the character of the transaction in the US but results in the transaction being regarded in country X as transferring the ownership in the airplanes to Easyair. As a result, both USCO and Easyair are regarded as the owner of the airplanes and each is able to claim depreciation deductions with respect to them.

As mentioned above,[811] HFIs and cross-border leasing differ in certain respects, making cross-border leasing a more specific case study alongside a more general case study in of HFIs. In addition, unlike HFIs where there is no specific policy underlying the different

[810] High minimum investment requirements may result if, for example, country Y uses the foreign tax credit as a relief mechanism and as a result, to benefit from HFI, domestic taxpayers are required to invest in at least 10% of the capital of the foreign corporation to qualify for the underlying foreign tax credit. To that extent, it is possible that the 10% requirement would necessitate high investment which would prove to be an entry restriction to some taxpayers.
[811] See pp. 221-222 above.

treatment of debt and equity and the tests used to distinguish between the two for tax purposes, there is an underlying tax policy behind the decision to grant depreciation deductions. For this reason, the analysis in this part is performed in two different levels. First, at the specific policy level, examining the compatibility of ITA with the underlying policy behind depreciation deductions. Second, at the country level, examining the compatibility of ITA with the international tax policy of the country in question.

Outbound

Looking at the transaction from the perspective of USCO's country of residence, the first question is whether granting the depreciation deductions is within the scope of the depreciation deductions legislation and in accordance with the rationale behind the legislation. The answer would depend on the country in question. *Prima facie*, it seems that the answer is no.

Just for illustration – in the UK, at present it appears that such transaction would not be within the type of transactions intended to be covered by the legislation. This is due to the identity of the lessee as a non-UK resident and to the fact the leased airplane is not planned to be used in the UK. The existence of depreciation deductions in the other country are irrelevant as the legislation is restricted in its application with respect to most types of export leasing whether or not ITA exists. There might be, however, compelling reasons at the country level that would make it beneficial for the UK to divert from its existing dislike of export leasing transactions.

In the US, however, the situation appears to be unclear. On one hand, there is a strong resistance towards export leasing, resistance that is evident by special regulations that are intended to extend the period of the lease and to spread the deprecations deductions as much as possible. At the same time, these regulations are not designed specifically against export leasing (but rather with respect to domestic leasing with tax exempt entities) and in fact the IRS has accepted, also in private letter rulings, transactions that applied the existing regulations together with the beneficial FSC regime to achieve a result that would make export leasing beneficial from an economic perspective. Not only that. Such transactions were accepted also when the other party to the transaction claimed depreciation deductions in his country due to ITA, making the issue an almost irrelevant consideration in the decision.

Thus, *prima facie*, the grant of depreciation deductions in a lease with a lessee that is not subject to tax in the US is probably outside the application of the accelerated depreciation deduction scheme. This general exclusion is subject to an important exception. It is probably correct to stipulate that as long as the lessor is not merely a financial institution but also a manufacturer of the leased asset and the asset is manufactured or produced in the US, the transaction is not contrary to US tax policy.

The rationale for the exception should be found at the country level, as the result of a desire to promote the competitiveness of US manufacturers,[812] the relatively limited scope and the apparent absence of abuse.

A better view is probably to regard the US depreciation policy as being limited to leases with lessees that are subject to US Federal income tax. At the same time and despite the above-mentioned policy, there is a parallel US policy to support and encourage domestic manufacturers who export their products abroad. As a result, export leasing that qualifies under the FSC/ETI regimes is economically beneficial despite the disadvantageous depreciation deductions. The outcome for our discussion is that even though outbound ITA is not compatible with and might not qualify under the depreciation policy examination, it should still be allowed because it is compatible with the country level policy analysis.

Moving to the country level, it is necessary to examine whether there is a policy reason to intervene and prevent ITA from the perspective of the lessor's country of residence.

Starting with the questions of neutrality and efficiency, although the benefit in cross-border leasing that benefits from an ITA is a timing benefit (as opposed to an additional set of deductions as it might be thought), allowing the ITA would create an incentive for domestic lessors to engage in export leasing as opposed to domestic leasing. Nonetheless, despite the incentive to engage in export leasing, such incentive does not necessarily come at the expense and instead of domestic leasing. Focusing on the US as an example, the compromise struck down with respect to Subpart F appears to imply that with respect to outbound investment involving active business income competitiveness takes precedence over CEN to the extent that there is a conflict. This result appears to constitute a reason for not intervening.

[812] The justification used in this context is that the FSC/ETI provisions are meant to neutralize and balance what is perceived by the US to be an "uneven" playing field. This, however, is not a view shared by the EU and WTO.

From a competition perspective, on one hand, allowing ITA would allow domestic lessors (who are also manufacturers or producers of the leased assets) to better compete vis-à-vis foreign competitors.[813] In our example, USCO, an airplane manufacturer would be able to better compete with non-US airplane manufacturers in the non-US markets.

At the same time, to the extent that there are other US corporations that are only selling their products in the domestic market, allowing corporations, like USCO, that sell their products both domestically and abroad to enjoy ITA and to better compete abroad might also have an impact on their ability to compete domestically vis-à-vis domestic taxpayers that are not operating abroad and thus does not enjoy the benefit of ITA.[814]

The outcome of this analysis depends on the answers to the following two questions: First, are there any domestic lessors that manufacture similar products but only market them to the domestic market. Second, are domestic lessors who engage in cross-border leasing at a competitive disadvantage in the absence of ITA. The answer to this question has to be given both vis-à-vis domestic lessors operating only in the domestic market and with respect to foreign lessors operating in the same market.

To the extent that the answer to the first question is no, then the entire focus is on the international level and the relevant question is whether the effect of the ITA is to level the playing field or to create a competitive advantage for the domestic lessor (USCO) vis-à-vis potential foreign competitors.

If the ITA has merely a neutralizing effect, then it would be easier to support it from a policy perspective. Even if, however, the ITA has the effect of creating a competitive advantage to USCO vis-à-vis foreign competitors, although there would be a stronger policy reason to object to the existence of ITA, it is not clear if there are strong policy considerations that would lead the US to relinquish the benefits enjoyed by its taxpayers especially when its tax policy is aimed at encouraging and assisting domestic taxpayers operating abroad.[815]

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[813] Whether or not the effect of the ITA is to provide the taxpayer with a competitive edge or merely to level the playing field depends on the view of the situation that exists without the ITA. For example, for many years, the US has argued that its taxpayers are in a competitive disadvantage vis-à-vis foreign corporations. This was also one of rationales behind the DISC legislation in 1971 that was later replaced with the FSC legislation (the other rationale was to encourage US companies to manufacture in the US and not in foreign jurisdictions. See the discussion above (pp. 45-46)).

[814] Although I make the distinction between taxpayers that sell in both domestic and international markets and those that only sell in domestic market, a more precise distinction would be between those that sell also in countries with which an ITA exists and those that do not.

[815] Due to the combination between the hostility against export leasing on one hand and the support for US manufacturing on the other hand, the existing legislation is structured in a way that would not be beneficial to taxpayers unless they qualify as a manufacturer, thus limiting significantly the potential for abuse.

To the extent that the answer to the first question above is yes, then the preceding analysis should be conducted both at the international level vis-à-vis foreign competitors and at the national level vis-à-vis domestic competitors. Here, the same reason that was good to justify ITA at the international level might be used to justify intervention at the domestic level because ITA provides companies like USCO with an advantage over other domestic lessors that only sell to the local market.[816]

The competitiveness argument goes well with the political consideration. To the extent that the industry is strong enough, its political influence should also be strong and make the competitiveness argument more compelling. Obviously, this depends to a large extent also on the country in question. As it is discussed above,[817] in general, the US tax policy is influenced by political considerations, which form an integral part of the discussion. This is especially true when the domestic taxpayers involved are in the manufacturing business which "allows" them to use the political argument even further, for example, to raise the risk of unemployment.[818]

In summary, in light of the US insistence over the last 30 years on retaining the FSC regime in one way or another[819] and the acquiescence of the IRS in the combination of FSC and cross-border leasing even if they result in ITA, it would appear that limiting or preventing ITA would go against US policy on the matter.

Inbound

From the perspective of the lessee's country of residence, at least the answer to the first question appears to be much more straightforward and clear. The asset that is leased is being used in the country and the lessee is a resident of the country. Thus, to the extent that the lessee is entitled to the depreciation deductions, this would agree with the rationale behind the depreciation deduction legislation, to promote and encourage business investment and investment capital assets in the country.

In effect, as Ring notes, the benefit of inbound double-dip is not only that the acquisition of assets is encouraged through generous timing in depreciation deductions, a benefit that is

[816] Although in the specific context of airplanes, the chances are very small to find a manufacturer and a lesser that only work with the domestic market, this distinction can exist in other industries.
[817] See pp. 98-109 above.
[818] One possible advantage can be the potential lack of political resistance because of the relatively narrow application of the ITA and the fact foreign manufacturers who might object do not vote in US elections.
[819] See generally our discussion above in the context of competitiveness, especially pp. 45-46.

also reflected in the price of the lease, but also in the fact that part of this benefit is funded by the other country.[820] *Prima facie*, it appears to be a good example where ITA should not be objected to. This, however, is subject to certain objections that might render a different conclusion.

First, still at the level of the policy behind the depreciation considerations. As it is mentioned above,[821] there are basically two main schools of thought regarding the use of depreciation deductions. The first believes that acquisition of new property should be encouraged by granting generous depreciation benefits that are reflected in accelerated pace of depreciation making the investment more beneficial to the party claiming the depreciation and through the lease mechanism also to the other party. If this school of thought is followed, then not only should inbound double-dip leasing not be objected to, it should actually be supported.

An alternative school of thought takes the position that the tax system through the grant of depreciation deductions should compensate the acquirer for the cost of the capital asset that can not otherwise be reflected in his tax status and reflect his true financial situation but not encourage any activity. Thus, the pace of the depreciation should be similar to the pace of economic depreciation on the asset. If this is the policy that is followed, then double-dip leasing which essentially accelerates the pace of depreciation and provides an encouragement to acquire new assets might go beyond the limits of this policy. The question is whether the fact that the extra benefit is provided for, partially at least, by the other country makes a difference. Arguably, the rationale behind the amount and pace of depreciation deductions takes into account also considerations of costs. A more limited and restrained expenditure can also reflect a decision on the part of a country not to spend money on a certain type of expenditure and to use the funds for other purposes. If, however, the expenditure is partly paid by another country, why should the country object to this?

A possible objection might exist in the form of equity. This objection has to be examined in two levels. At the first level, among taxpayers who use leasing those who have and those who do not have access to cross-border leasing. At the second level, the examination is made among taxpayers that can use leasing and those that cannot use leasing to finance their operations.

[820] Ring (2003).
[821] See p. 174 above.

One mitigating argument is the spillover effect, the possibility that the benefits of double-dip leasing would affect other leasing as well as other finance methods, lowering the costs of finance and benefiting indirectly a large group of taxpayers that might not benefit directly.

At the country tax policy level, there are several additional objections although it appears that the arguments in favor of ITA outweigh the objections.

On one hand, ITA can be objected to because it favors foreign lessors and foreign manufacturers over domestic lessors and manufacturers. This competitiveness argument is closely related to political considerations. To that extent, the political argument made above[822] can also be used here in this context with the necessary changes.

A similar argument can be made by domestic financing institutions that are unable to provide finance on similar terms to domestic corporations as they lack the double-dip benefits. To that extent, it is necessary to determine whether an open or protectionist approach would better suit. The problem in this approach is that it requires the country to raise the cost of finance to some of its taxpayers to make it equal for all.

On the other hand, such leases reduce the cost of finance for the domestic corporation leasing the asset. Thus, ZCO in our example above would be able to lease the same asset but at a lower cost due to the ITA. This will have an effect not only on the cost of finance but also on the ability of ZCO to compete provided it is able to use for other purposes funds that are available as a result of the lower financing of the asset. Depending on the extent of the saving and the scope of the finance that benefits from the ITA, it might also be possible to argue the above-mentioned political argument in reverse. To the extent this becomes possible, then the legislator might have to distinguish between two competing competitiveness and political arguments.

In addition, allowing domestic taxpayers to enjoy ITA can have the potential of making the country more attractive as an investment location. The country would benefit because it has potential of increasing the business activity in its territory without frustrating the underlying objective of the expenditure legislation. Taxpayers would be justified, as they will be able to enjoy cheaper finance to expand their business and become more competitive.

[822] See pp. 67-71 and 231 above.

In the context of the UK, this can have an added benefit. As it was discussed above,[823] EC law imposes limitations both of the ability of MS to offer attractive investment incentives and on their ability to protect their revenue base. In the context of ITA, while the existence of ITA is not expected to violate EC law, attempts to prevent it do. As it is discussed above,[824] one way of overcoming the problem of ITA is to change domestic law in a way that would not only make sense domestically but also internationally. *Prima facie*, the suggested reform in the treatment of cross-border leasing is the step in this direction. The provision is meant to achieve consistency domestically but it is also important to examine its possible application in a cross-border setting. To the extent that it is going to create opportunities for inbound ITA, it is unlikely to be held in violation of EC law and it is likely to attract investment into the country and encourage leasing by UK lessees. There might be also some disadvantages to such an approach. For example, domestic lessors might find themselves in a disadvantage vis-à-vis foreign lessors. Nonetheless, my argument is that ITA should not be treated with hostility all the time. There might be situations in which it would present a good policy move.

EC law and the UK

I have outlined an approach to assessing ITA that has the quality of analyzing the desirability of an intervention in the light of both international tax policy and the specific policy of the area of the law in which ITA takes place. By way of illustration I would like to complete the analysis by looking more closely at the considerations that EC law raises for the UK's approach to ITA.

In the case of the UK, an additional consideration in the analysis is compatibility of the desired solution with EC law. The addition of EC law considerations to the UK tax policy analysis both in general and in this particular situation of ITA gives rise to two issues. The first issue concerns the need for a UK legislative reaction to be compatible with EC law. In contrast to the situation under international law, the UK, by entering into the EU agreed to restrict its ability to adopt legislation that does not agree with EC law. While this limitation is not new, the special nature of ITA makes it peculiar, as it is the reaction as opposed to the perceived abuse that is restricted.

The second issue concerns the need for the UK in general to be attractive enough to attract foreign investments especially in light of the likely competition from other European

[823] See pp. 81-95 above.
[824] See pp. 186-188 above.

countries, for example, Germany. This concern coupled with existing EC law restrictions on fiscal incentives might cause the UK to reconsider and use existing ITA to operate to its advantage. This is enhanced by the need to raise money to finance the public sector and to lower the burden on other more mobile sources of funds leading to a search for new sources. This trend was clearly visibly in the recent budget where a crackdown on tax avoidance was announced in an attempt to raise more funds to finance the public sector. The need to raise more revenues to finance the public sector becomes much more important in the light of the potential liability UK might have with respect to past violation of EC law, placing the UK in an interesting position from a tax policy perspective.

On one hand, the UK is dependant on foreign investments, most of which are almost equally divided between the US and the EU making it very important to keep the UK as an attractive place for investments, both direct and portfolio investments. Thus, in its publications and press releases in recent years, the Inland Revenue has stressed the need to create an efficient and competitive system that would be able to compete in the global markets and attract investments on one hand and would prove beneficial for its taxpayers on the other hand.

From outside the EU, the desire on part of the UK to serve as the gateway to the EU from countries like the US necessitates the need to retain competitiveness especially vis-à-vis other EU member states.[825] Overall, the UK has to strike a balance between keeping its attractiveness as a location for investments (as well as a location of its existing MNEs) on one hand and its need to raise revenue on the other hand. The option of granting certain benefits to its residents without extending them to other non-resident EU taxpayers is no longer available.

ITA, to a large extent, fit the general objective of the EC Treaty as contained in the first articles of that treaty by encouraging cross-border activity and investment. In addition, the Four Freedoms of the EC Treaty coupled with the strict application by the ECJ put additional burden on MS that seek to prevent ITA by adopting unilateral measures for that purpose. To qualify, it will be necessary to establish that ITA equals tax avoidance and that the adopted measures satisfy the four conditions set forth by the court in *Gebhard.*

Moreover, even existing restrictions that restrict cross-border transactions and as a result also make ITA less available as a practical matter are now under the scrutiny of the ECJ. Recent

[825] This need and its application in practice can be seen in the 2001 US-UK tax treaty that provided the UK with some important benefits vis-à-vis other EU member states and was criticized for that, questioning whether it is compatible with EC law. See for example, the 0% withholding tax on certain dividends, which was the first of its kind in treaties with the US and represents an advantage held among EU states only by the UK.

decisions in *Lankhorst-Hohorst* and *Bosal Holding* made it clear that the ECJ is interested in removing barriers and obstacles that stand in the way of achieving the goal set forth in Art. 3(1)(c) of the EC Treaty and will not be afraid to hold a legislation to be incompatible with EC law if this legislation is found to be discriminatory or restrictive in any form and it does not qualify under one of the limited narrow exceptions provided either by the EC Treaty or by case law.

Although the forthcoming test of the ECJ in *Marks & Spencer* will determine how far the court is really willing to go, existing case law already establishes an easy ground for ITA, where ITA is generally allowed and MS can only limit the existence of ITA with legislation that fits into the narrow exceptions provided by the EC Treaty and by the courts. For example, it is doubtful whether certain measures that are currently aimed at restricting ITA would stand the scrutiny of an ECJ challenge because such legislation is based on TA 1988 s.212 whose validity under EC law principles is, at best, questionable.

The current situation in the EU, with very limited positive legislation on direct tax matters on one hand and a very extensive and developed case law that forces the removal of obstacles for a common internal market on the other hand, present a challenge to MS by inducing them into competition on revenues, whereby some of the methods that can be used are either prohibited or restricted by EC law and such limitations are carefully reviewed by the ECJ.

The only alternative, apart from a multilateral measure that is probably unlikely, is to change the entire legislation to make a certain type of ITA irrelevant. ITA, however, is not a sufficient reason for that purpose and it would usually require much more to be at stake.

A good example is the 2003 proposal to amend the UK tax treatment of leasing by adopting a more accounting oriented approach and granting the capital allowances in a finance lease to the lessee instead of the lessor. This legislation, designed to solve the export leasing problem by removing the restrictions on export leasing while at the same time not losing UK revenues for such a move, is likely to make it very difficult to create outbound double-dip leasing out of the UK. At the same time, it might introduce new ITA and planning opportunities for inbound cross-border leasing from countries that classify leases based on their legal form, making the UK an attractive destination.

Alternatively (or in addition) the UK might want to consider using ITA to its own advantage thus raising the need revenues on one hand and keeping its attractiveness on the other hand.

Such an approach would require a change in the priorities of the UK in its analysis whether the specific ITA warrants intervention.

The prerequisite question in such an analysis should probably be revenue loss, mainly due to the increasing importance raising revenue has at present. If the ITA in question does not result in revenue loss to the UK or in a revenue loss that is acceptable in the light of the associated benefits, then other considerations can be taken into account.

Conclusions

In this thesis I have tried to discuss the dilemma of ITA and in doing so to establish a few points.

First, the dilemma of ITA does not have a clear answer. As it was already established before,[826] ITA is not a question of all of nothing. As a result, different situations of ITA are likely to give rise to different answers regarding the appropriate reaction to ITA.

Second, in discussing ITA, many considerations that are usually not involved in policy discussion should be included. These considerations that should also be included in non-ITA policy discussions have significant effect on the outcome of the discussion and are able to offer possible explanations to policy decisions taken by countries. Such considerations would usually include consideration of foreign policy and political considerations.

Third, policy decisions are usually made at the country's level. As such, they tend to accommodate the needs of the system applying them. In the two case studies I have examined in this work, more than one approach exists to determine the tax treatment of a HFI or a cross-border lease.

The case studies represent two distinct situations of ITA. Whereas HFIs are instruments that are intended to be classified based on an arbitrary premise and by applying arbitrary criteria, cross-border leasing and in particular the grant of depreciation deductions, have a valid policy goal and although they are applied using an arbitrary set of rules, their application is made by reference to the underlying purpose behind the legislation.

In both areas, HFIs and cross-border leasing, more than one method exists for the determination of the tax consequences of a given transaction. One method is to follow the economic substance of the transaction to determine its classification. An alternative method is to respect the legal form of the transaction. ITA is usually obtained when one country follows a certain method, the other country follows a different method, and together the combination of the treatment in the two jurisdictions provides a benefit to the taxpayers involved in the transaction.

A detailed analysis of the laws in both the US and the UK in the two case studies has established the following observations:

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[826] See p. 216 above.

1. In each country the tax laws are applied independently of the application in the other jurisdiction.
2. While the general rule is that the US should follow the economic substance approach whereas the UK should follow the legal form approach, in practice the situation is not that clear and both countries deviate from the general rule. A good way to illustrate this is to use an observation that was made with respect to the US tax system in general – "*substance controls form unless form controls substance.*"[827] As a result, ITA is usually not the outcome of a general mismatch between two systems but rather a difference in approach in specific situations where the two countries involved choose to treat the same transaction differently.
3. This difference in approach can be partially explained by the fact that the law in each tax system developed independently, responding to tax planning in that jurisdiction whereby taxpayers attempted to use discontinuities in the system to their advantage and tax authorities responded with legislation and case law. Foreign law that developed in a different way created opportunities for taxpayers to use not only domestic inconsistencies but also international discontinuities to their advantage. In the context of cross-border leasing, it appears that in an attempt to limit taxpayers' ability to claim the first dip, different countries developed provisions that in effect allow the double-dip to take place. A recent example is the Inland Revenue proposal to reform the taxation of leasing in the UK by treating finance leases and some operating leases as transferring the ownership to the lessee who then becomes entitled to claim depreciation deductions. While this proposal is in line with other domestic legislation and is meant to achieve greater neutrality in domestic transaction, it has the potential effect of creating new ITA opportunities in the UK.
4. Over the years, each jurisdiction developed body of statutory provisions and case law dealing with cross-border transactions. This body of law has not been developed in relation to ITA but rather to general cross-border transactions. Nonetheless, its application to cross-border transactions, which also include ITA, makes it essential for ITA to satisfy the requirements of these cross-border provisions for the ITA to actually take place. In some situations, these general cross-border provisions would deny the existence of ITA or limit it significantly. This is especially relevant in the context of cross-border leasing where special provisions have been adopted by the US and the UK to deny or defer depreciation deductions where the lessee is not

[827] McMahon (2002).

subject to tax in that country. In the UK, these provisions make the question of outbound ITA a moot question.

In that sense, ITA illustrates the importance of considering the application and reaction of foreign tax law in the formulation of domestic tax law.

Fourth, at the policy level, the analysis should take place at two different levels, first, examining the rationale behind the distinction in domestic law (to the extent such rationale exists) and second by examining the consequences of ITA and its compatibility with the international tax policy of the country in question.

The two main themes that were developed in the thesis through the case studies have been the effect of political considerations as a consideration in determining tax policy and the potential impact of EC law on UK tax legislation. The former has been clearly evident when I have examined US tax policy. Unfortunately, its role has not always been acknowledged. With respect to EC law and the UK, the analysis suggests that ITA is not necessarily a problem.

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