

FLORIDA TAX REVIEW

VOLUME 3

1996

NUMBER 4

Foreign Law in U.S. International Taxation: The Search for Standards

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I. INTRODUCTION

Among U.S. tax professionals, references to international taxation commonly encompass two things: the U.S. tax rules that apply to the U.S. income of non-U.S. persons, and the U.S. tax rules that apply to the non-U.S. income of U.S. persons. In both cases, the focus is on U.S. rules. Frequently, however, foreign law affects the application of these U.S. rules. This article examines the role of foreign law in U.S. international taxation.¹

In a variety of contexts, U.S. tax law either explicitly or implicitly requires an interpretation of foreign law or allows for an argument that foreign law is relevant to U.S. tax consequences. Neither the courts nor the Treasury has, however, articulated a standard for determining when foreign law should be taken into account and, where foreign law is taken into account, what its proper role should be in the interpretation of U.S. tax rules. As a result, taxpayers and the government continue to dispute the role of foreign law in interpreting U.S. tax rules. Even different courts may take different views of the relevance of foreign law to what appears to be the same U.S. tax issue.²

Part II of this article seeks a principled basis for resolving these disputes and reconciling these authorities, and proposes a standard for determining when and how foreign law should be taken into account in determining U.S. tax consequences. In brief, Part II shows that, contrary to

1. Some 15 years ago, Charlie Kingson wrote the most thoughtful piece yet published on how and to what extent the United States takes into account the foreign treatment of international income. See Charles I. Kingson, *The Coherence of International Taxation*, 81 *Colum. L. Rev.* 1151 (1981). He advanced the proposition, supported in exquisite detail, that U.S. tax legislative policy and treaty policy must be formulated in light of and with regard to (in coherence with) the tax policies of our trading partners. This article builds on Kingson's thesis, primarily by proposing a standard for how tax statutes and treaties should be interpreted when the taxpayer or the government invokes foreign law as a factor affecting U.S. tax consequences, and secondarily by making specific tax policy recommendations with respect to U.S. law/foreign law interactions affecting cross-border tax arbitrage transactions.

The role of foreign law in the interpretation of U.S. tax law was directly addressed by Joseph Isenbergh over a decade ago. See Joseph Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes*, 39 *Tax L. Rev.* 227 (1984). Isenbergh traced the government's search for the contours of a creditable foreign tax. Recognizing the definitional and practical difficulties of distinguishing creditable foreign taxes from other, noncreditable payments to foreign governments, he proposed that "in all but the most transparent cases," all foreign government levies should be creditable, whether or not they are taxes. *Id.* at 229. As discussed in greater detail below, it is this author's view that the U.S. Treasury need not give up by allowing U.S. tax credits for nontax payments to foreign governments by U.S. taxpayers and their subsidiaries.

2. Compare *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989) with *Vulcan Materials Co. v. Commissioner*, 96 T.C. 410 (1991), *aff'd per curiam*, 959 F.2d 973 (11th Cir. 1992), nonacq. 1995-1 C.B. 1. See Part II.B., *infra*.

the implications of several IRS positions regarding the irrelevance of foreign law in determining U.S. tax consequences,³ the cases are consistent in allowing “factual” uses of foreign law and prohibiting “interpretive” uses of foreign law.⁴ Foreign law is used factually when it is proven as an evidentiary fact tending to show that a U.S. legal standard was or was not satisfied. Foreign law is used interpretively when it is used as a rule of decision, when the meaning to be given a term in a U.S. statute or other rule is determined by or with reference to the meaning of that term under foreign law.

As a consequence, the issue of whether foreign law is relevant to U.S. tax consequences in a particular situation can be resolved on the basis of whether an interpretive or factual use of foreign law is being advocated. Once it is determined that a factual use is being advocated, the foreign law cannot be dismissed as irrelevant based solely on the cases that have rejected particular uses of foreign law.⁵

As discussed below, the factual/interpretive distinction is useful for other purposes as well. For example, it provides a basis for rules that would ease the administrative burden on the IRS regarding its use of foreign law, without ignoring relevant tax policy concerns.

Part III examines the role of foreign law in transactions offering tax results that, at first blush, appear too good for taxpayers to be consistent with sound tax policy: cross-border tax arbitrage transactions. Evaluating such transactions, which involve the favorable and inconsistent tax treatment of an item by two or more jurisdictions, requires a sequential resolution of several factual and tax policy questions. For example, is foreign law relevant in any way to the U.S. tax consequences? If it is, is favorable tax treatment in the United States predicated on consistent tax treatment abroad, or is foreign law relevant only in that it must be consulted in a factual sense to help determine U.S. tax consequences? If favorable U.S. tax treatment is thought to be conditioned on consistent tax treatment abroad, is this condition explicit or merely implicit? Can an implicit condition of consistency be a legitimate basis for the IRS to attack a transaction?

In the analysis of cross-border tax arbitrage transactions, it is submitted that, except in the treaty context, an implicit condition of

3. See, e.g., *Exxon Corp. v. Commissioner*, 66 T.C. Memo (CCH) 1707, 1737, T.C. Memo (P-H) ¶93,616, 93-3261 (1993) (IRS argument against applying foreign law); Action on Decision CC-1995-002 (Feb. 13, 1995), available in LEXIS, FEDTAX library, RELS file.

4. An exception is the unusual case in which the relevant statute or its legislative history expressly contemplates an interpretive use of foreign law.

5. Collateral questions about whether a given foreign rule is a “law” or whether the taxpayer has colluded with the foreign government to achieve certain tax results must be addressed, but they go to the evidentiary weight to be accorded the foreign law, not to whether foreign law may be used to help determine U.S. tax results.

consistency is tantamount to an interpretive use of foreign law. Absent an explicit requirement of consistency, inconsistent treatment of a transaction may therefore provide a reason for the United States to revise its rules, but it may not serve as the basis for an attack on the transaction as long as no rules of either jurisdiction are violated. Moreover, if the standard for the use of foreign law were the IRS' (overly) broad position that foreign law is *per se* irrelevant in determining U.S. tax consequences, such an attack would even more clearly be improper.

II. USE OF FOREIGN LAW BY THE COURTS, THE TREASURY, AND THE IRS

Several cases, decided in various contexts, have looked to foreign law in determining U.S. tax consequences. The Treasury has also expressed its view on this subject in the form of regulations and other guidance issued in discrete areas. In other contexts in which the issue arises, it has not been addressed by the courts or in other published authority. But even in contexts in which the issue has been addressed, neither the courts nor the executive branch has articulated a consistent guiding principle for the use of foreign law. It is thus frequently unclear whether and to what extent foreign law should be taken into account.

Foreign law has been examined to determine U.S. tax results in the following situations:

- ♦ In 1938, the Supreme Court decided that U.S. and not foreign legal principles should govern whether a taxpayer is entitled to foreign tax credits under the predecessor to section 901.⁶ The issue in that case, whether a taxpayer "paid" the tax for which it claimed credit, still stirs up controversy today.⁷
- ♦ In separate cases, the Supreme Court and the Tax Court recently addressed the impact of foreign law on a U.S. multinational corporation's entitlement to credits under section 902 for foreign taxes imposed on a foreign subsidiary.⁸ The IRS has also addressed this issue in recently proposed regulations.⁹

6. *Biddle v. Commissioner*, 302 U.S. 573 (1938).

7. See, e.g., *Norwest Corp. v. Commissioner*, 69 F.3d 1404 (8th Cir. 1995); *Continental Ill. Corp. v. Commissioner*, 998 F.2d 513 (7th Cir. 1993), cert. denied, 114 S. Ct. 685 (1994).

8. *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989); *Vulcan Materials Co. v. Commissioner*, 96 T.C. 410 (1991), aff'd per curiam, 959 F.2d 973 (11th Cir. 1992), nonacq. 1995-1 C.B. 1.

9. Prop. Regs. §§ 1.902-1(a)(9)(iv), -1(a)(10)(ii).

- ◆ Although U.S. taxpayers are allowed credits for foreign income taxes, they may not claim credits for payments that are not taxes. The Treasury issued no fewer than four sets of regulations¹⁰ that attempted to provide a framework for evaluating foreign laws that nominally impose taxes but that also can be viewed as providing for royalty or other payments for mineral deposits or other goods or services provided by the foreign government.¹¹
- ◆ Several recent cases have addressed the extent to which restrictions of foreign law on payments between related persons should be taken into account in analyzing whether the prices charged and paid by them are the same as those that would have been charged and paid by unrelated persons acting at arm's length.¹² The Treasury has issued regulations reflecting its views on this issue as well.¹³

In other contexts, foreign law is relevant to U.S. tax consequences because inconsistent treatments of an item under the laws of different jurisdictions raise the tax policy question of whether a particular treatment of an item under foreign law should preclude an inconsistent treatment of that item under U.S. law:

- ◆ In a ground breaking development, the IRS recently proposed regulations that would allow most legal entities to determine whether they will be taxed as corporations or as partnerships simply by checking a box on a form.¹⁴ The IRS initially suggested that the extraordinary benefits of this proposal might be withheld from foreign entities, in part because of concerns about the consequences where U.S. and foreign law classifications of an entity are not

10. See Regs. §§ 1.901-2, 1.901-2A, 1.903-1 (48 Fed. Reg. 46,272, 46,284, 46,295 (1983)); Prop. Regs. §§ 1.901-2, 1.901-2A, 1.903-1 (48 Fed. Reg. 14,641, 14,643, 14,650, 14,658 (1983)); Prop. Regs. § 1.907-1 (45 Fed. Reg. 75,695 (1980)); Prop. Regs. §§ 1.902-2, 1.903-1 (44 Fed. Reg. 36,071, 36,072, 36,076 (1979)). Amendments to § 1.901-2(e)(3) were proposed on November 15, 1988 (53 Fed. Reg. 45,943 (1988)) and finalized on October 31, 1991 (56 Fed. Reg. 56,007 (1991)).

11. See generally Isenbergh, *supra* note 1, at 260-80.

12. *Exxon Corp. v. Commissioner*, 66 T.C. Memo (CCH) 1707, T.C. Memo (P-H) ¶ 93,616 (1993); *Procter & Gamble Co. v. Commissioner*, 95 T.C. 323 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

13. See Regs. § 1.482-1(h)(2); Regs. § 1.482-1(a)(3) (before amendment in 1994).

14. PS-43-95, 61 Fed. Reg. 21,989 (1996). The proposed regulations were preceded by an IRS request for comments on the check-the-box idea. I.R.S. Notice 95-14, 1995-1 C.B. 297.

consistent.¹⁵ The proposed regulations, however, allow the check-the-box election to be made by many foreign entities.¹⁶

- ◆ The issuer of a financial instrument may treat it as debt (to generate interest deductions), while the holder, residing in another country, treats it as equity under the laws of that country (e.g., to provide a dividends-received deduction). Similarly, taxpayers may structure a lease so that the lessor resides in a jurisdiction that provides depreciation deductions to the legal title holder and the lessee resides in a jurisdiction that provides depreciation deductions to the holder of the economic benefits and burdens of ownership.¹⁷

In all of these situations, and in many others,¹⁸ the issue is whether

15. See Notice 95-14, *supra* note 14, at 298 (“A second consideration in the foreign area is the possibility of inconsistent, or hybrid, entity classification; that is, classification as a taxable entity in one country but as a flow-through entity . . . under the tax laws of another country”).

16. Prop. Regs. § 301.7701-3(a). Generally, the election would be available to a foreign entity unless it is organized under laws analogous to the corporation laws of the states of the United States. See Prop. Regs. § 301.7701-2(b)(8).

That the application of the existing rules for classifying a foreign entity require “a thorough understanding of the controlling foreign law” is cited as a reason for allowing the election to foreign entities. PS-43-95, *supra* note 14.

17. See Leo F. Naughton, *International Leverage and Facility Leasing in the United States*, 44 N.Y.U. Inst. ch. 47, § 47.04 (1986).

18. See, e.g., IRC § 404A(d) (linking the treatment under U.S. and foreign tax law of certain payments and accruals under foreign deferred compensation plans); § 865(g)(2) (conditioning the treatment of certain U.S. persons as nonresidents on the imposition of foreign taxes on gains realized in property sales); § 891, 896 (permitting the President to increase tax rates on citizens and corporations of countries whose tax laws are found to discriminate against U.S. persons); § 954(b)(4) (excepting from subpart F certain income subject to high foreign taxes); § 999 (establishing an “international boycott factor,” which may result in reduction of the available tax credit to taxpayers participating in a boycott of Israel); § 1504(d) (permitting consolidation of certain subsidiaries formed in contiguous foreign countries solely for purposes of complying with those countries’ laws as to title and operation of property); Temp. Regs. § 1.367(a)-4(f) (exempting a transfer of assets to a foreign corporation from gain recognition under § 367(a) if, among other things, the transfer is “legally required by [a] foreign government as a necessary condition of doing business in that country”); Prop. Regs. §§ 1.1441-1(c)(6)(ii)(B), -6(b)(4) (for purposes of claiming reduced rate of withholding tax under a treaty, looking to tax principles in effect in the country whose treaty is being revoked); § 1.1296-4(c) (linking qualification as an “active bank” for PFIC purposes to foreign licensing rules); Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 28, 1993 [hereinafter *Mexican Treaty*], art. 24, para. 3 (treating as foreign source income for U.S. foreign tax credit purposes, capital gains of a U.S. resident that are taxed by Mexico in accordance with the treaty despite the contrary general rule of § 865(a)).

foreign law should be taken into account and, if so, how. The following sections attempt to answer those questions.

A. "Legal Liability" Under Section 901

1. *Biddle Decision*.—In 1938, the Supreme Court issued what is commonly viewed as the seminal opinion on the impact of foreign law in the foreign tax credit area, *Biddle v. Commissioner*.¹⁹ Even outside this area, the *Biddle* case is frequently the starting point for any discussion of the impact of foreign law in U.S. tax analysis.

The issue in *Biddle* was whether a shareholder was entitled to credit under the predecessor of section 901 for U.K. taxes on corporate earnings that were distributed to the shareholder.²⁰ Ms. Biddle received a dividend from a U.K. corporation, accompanied by a statement showing the amount of the dividend and the amount of tax "appropriate" thereto. Somewhat simplified, the appropriate tax was the aggregate tax to be paid by the corporation and the shareholder under the U.K. integrated tax system. Assuming distribution of all corporate earnings, the sum of the cash dividend and the tax appropriate to the dividend equaled the corporation's pretax earnings. For both U.S. and U.K. tax purposes, Ms. Biddle reported as income the cash dividend and the U.K. tax appropriate thereto and, for U.S. tax purposes, she claimed credit for the tax appropriate to the dividend.

The characterization of a payment under foreign law has also been determinative, on occasion, of the source of income. For example, in *Karrer v. United States*, 152 F. Supp. 66 (Ct. Cl. 1957), the taxpayer was a nonresident alien who had made a contract with a foreign pharmaceutical manufacturer. The taxpayer granted the foreign manufacturer all rights in certain processes invented by the taxpayer in exchange for a fixed percentage of the manufacturer's future sales. Under Swiss law, the contract was treated as a services contract, rather than one involving royalties. The foreign manufacturer licensed the rights to a U.S. manufacturer, which agreed to pay the requisite percentage of sales proceeds to the taxpayer. The IRS argued that the payments were in the nature of U.S. source royalties. The taxpayer argued that the payments were for services rendered outside the United States and as such were not U.S. source income subject to tax. The Court of Claims held that the nature of the payments was governed by the treatment under Swiss law of the contract between the taxpayer and the foreign manufacturer.

19. 302 U.S. 573 (1938).

20. The U.S. tax system is a so-called "classical" system, subjecting income to a tax at both the corporate level and the shareholder level. By contrast, most other industrialized countries have adopted "integrated" systems, whose goal is to tax corporate income only once, even if distributed to the corporation's shareholders. This is generally achieved by providing tax credits to shareholders for taxes paid at the corporate level ("imputation" system). The Treasury has studied the issues that would arise in integrating the U.S. tax system. See Report of Dep't of Treasury, *Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once* (U.S. Gov't Printing Office, Jan. 1992). For a fascinating recent case involving the U.K. imputation system, see *Xerox Corp. v. United States*, 41 F.3d 647 (Fed. Cir. 1994), cert. denied, 116 S. Ct. 72 (1995).

The question in the case was whether the U.K. taxes were “paid” by the taxpayer/shareholder, as required by the applicable U.S. statute.²¹ In addressing this issue, the Court analyzed the requirements of British law regarding payment of the tax by the stockholders and evaluated whether the actions so required of the stockholders were the substantial equivalent of payment of the taxes in the U.S. sense.²²

Under British law, the corporation, not the stockholder, was actually required to pay the tax. By the weight of British authority, the stockholder was not liable for the tax, even if the corporation defaulted in payment; the remedies for nonpayment ran against the corporation, not the stockholder. Moreover, in the absence of dividends, the corporation was required to pay tax on its profits, and no tax was paid by the stockholder. All of these requirements of British law indicated that the corporation and not the stockholder “paid” the tax, as that term was used in the U.S. sense.

Conversely, the Court noted that the stockholders bore the tax burden “in substance.” Moreover, if the stockholder’s income were exempt from U.K. tax, the stockholder would get a refund of her proportionate share of any tax paid by the corporation. Finally, any liability of the stockholder for surtax (another U.K. tax applicable to certain stockholders) was computed on the gross dividend (i.e., the dividend plus the tax appropriate to the dividend).

The Court quickly dismissed these countervailing considerations. With respect to the tax burden in substance being on the stockholders, the Court asserted that all corporate income taxes are borne economically by the stockholders.²³ The stockholders are not, however, viewed as having paid a corporate tax for foreign tax credit purposes. The Court stated that the other countervailing considerations are logical concomitants of an integrated system, but the United States has no such system. Therefore, they are not indicative of whether the tax is “paid” by the stockholders as that term is used in a U.S. sense.

It is an oversimplification to read *Biddle* as standing for the broad proposition that U.S. principles, not foreign principles, govern U.S. tax

21. The present statutes also limit the credit to taxes “paid or accrued.” IRC § 901(b)(1), (2), (3). The unstated statutory requirement is that the taxes be paid by the taxpayer claiming the credit.

22. According to the Court, the phrase “income taxes paid” has “for most practical purposes a well understood meaning to be derived from an examination of the statutes which provide for the laying and collection of income taxes.” *Biddle*, 302 U.S. at 579.

23. More recently, economists have discussed whether corporate taxes are borne by the corporation’s shareholders, its customers, its employees, or some combination of the foregoing. See, e.g., Joseph A. Pechman, *Federal Tax Policy*, 141-48 (5th ed. 1987); Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 *J. Pol. Econ.* 215 (1962); Merton H. Miller & Myron S. Scholes, *Dividends and Taxes: Some Empirical Evidence*, 90 *J. Pol. Econ.* 1182 (1982).

consequences.²⁴ The Court did not disregard British law. Rather, it analyzed what the British law required of the stockholder and whether that was the substantial equivalent of payment of the tax as that term is used in the U.S. statute. Although the Court refused to define a term used in a U.S. statute by looking to the manner in which the term is defined under U.K. law,²⁵ it was perfectly willing to look to U.K. law to determine whether the facts of the case warranted a finding that the U.S. statute's terms had been met.

Biddle may be seen as applying a relatively narrow rule of statutory construction: When a statutory term is not defined in any relevant U.S. law, its legal meaning is derived from its plain meaning in the English language as used in the United States.²⁶ However, once the word is defined to establish a standard, a court, in applying that standard, is required to determine what, as a matter of fact, the taxpayer in a particular case did and did not do. If what the taxpayer did and did not do is a function of what is required and prohibited under foreign law, an examination of the foreign law may be perfectly appropriate.

The use of foreign law rejected by the *Biddle* Court may be referred to as an interpretive use of foreign law. Under an interpretive use, foreign law supplies the definition of terms contained or implicit in a U.S. statute and is therefore used as a rule of decision. Conversely, the use of foreign law accepted by the Court may be referred to as a factual use of foreign law.

24. Both the *Vulcan Materials* A.O.D. (Action on Decision CC-1995-002 (Feb. 13, 1995), available in LEXIS, FEDTAX library, RELS file) and the government's position in *Exxon Corp. v. Commissioner*, 66 T.C. Memo (CCH) 1707, T.C. Memo (P-H) ¶ 93,616, 93-3261 (1993), appear to be premised on a broad interpretation of *Biddle's* progeny. Although a detailed discussion of the relevant authorities is premature at this point, it is useful to note here that, in the *Vulcan Materials* A.O.D., *Vulcan Materials* is summarily found to conflict with *Goodyear*, without any attempt to determine the outer limits of *Biddle* and *Goodyear*. Similarly, in *Exxon*, the logical conclusion to be drawn from the government's argument is the radical position that *no* use of foreign law is acceptable in determining U.S. tax consequences. See *Exxon*, 66 T.C. Memo (CCH) at 1737 (describing IRS argument that *Procter & Gamble* (holding that § 482 could not be applied to impute income payment forbidden by foreign law) was wrongly decided because foreign law is difficult to apply, foreign governments should not dictate U.S. tax policy, and the legislative history of § 482 does not support extension of *First Security Bank* to the foreign context).

25. The Court stated that the statutory language "must be taken to conform to its own criteria unless the statute, by express language or necessary implication, makes the meaning . . . and . . . operation of the statute . . . depend upon its characterization by the foreign statutes and by decisions under them." *Biddle*, 302 U.S. at 578. Finding no such language or implication in the U.S. foreign tax credit statute, the Court held that U.K. law's treatment of the stockholder as the payor of the tax was at most a factor in determining whether the stockholder paid the tax within the meaning of the U.S. statute. *Id.* at 579.

26. As a corollary, this meaning cannot be altered or illuminated by other meanings, including specialized American meanings (such as scientific meanings) and meanings ascribed by foreign statutory or judicial authorities.

Under a factual use, foreign law is proved as an evidentiary fact. In *Biddle*, foreign law was proven as a fact tending to show that the stockholder was not the person who “paid” the tax, as that term is used in the U.S. sense.²⁷

In the author’s view, *Biddle* was correct in freely accepting a factual use of foreign law, but rejecting an interpretive use in the absence of a showing that the statute was intended to be interpreted in accordance with

27. Courts have adopted the factual/interpretive distinction, at least implicitly, in analyzing the impact of state law on federal tax consequences. Legal interests are created by state law, but federal income tax statutes determine the tax consequences of those interests. See *United States v. Irvine*, 114 S. Ct. 1473, 1481 (1994); *Morgan v. Commissioner*, 309 U.S. 78, 80-81 (1940); *Burnet v. Harmel*, 287 U.S. 103, 110 (1932). See also *United States v. Mitchell*, 403 U.S. 190, 197 (1971). As one commentator has stated, “the substantive rule is federal, and *state law merely establishes some of the facts* to which the court applies federal law in order to reach its conclusions.” Note, *The Role of State Law in Federal Tax Determinations*, 72 Harv. L. Rev. 1350, 1351 (1959) (emphasis added).

The Treasury has taken the same approach. For example, the classification of an entity as a partnership or association under state law is irrelevant to its status for federal income tax purposes. See Regs. § 301.7701-1(c) (stating that the Internal Revenue Code, not local law, establishes the standards applied in determining the classification of an entity). However, federal entity classification depends on the rights, duties, and relationships that are prescribed by state law. See Regs. § 301.7701-1(c). See also Rev. Rul. 88-8, 1988-1 C.B. 403 (extending this approach to foreign entities); but cf. PS-43-95, 61 Fed. Reg. 21,989 (1996) (proposing “check-the-box” elective entity classification). As another example, the definition of a life insurance contract may include certain arrangements, whether or not they are treated as insurance contracts under state law. See IRC § 7702(j)(1).

Ultimately, it is the intent of Congress that determines the role of state law. For example, under § 2053(a), the estate tax deduction for “administration expenses” appears to turn upon whether the expenses are allowable under state law, but the Treasury has attempted to impose an additional federal law requirement that such expenses be “necessary.” See Regs. § 20.2053-3. The federal courts are split on the validity of the additional requirement. Compare *Estate of Park v. Commissioner*, 475 F.2d 673 (6th Cir. 1973) (statute looking solely to state law preempts broader regulations) with *Estate of Love v. Commissioner*, 923 F.2d 335 (4th Cir. 1991). However, this dispute is not so much over the proper role for state law generally, as the role that Congress intended for state law in this particular context. See generally Paul L. Caron, *The Role of State Court Decisions in Federal Tax Litigation: Bosch, Erie, and Beyond*, 71 Or. L. Rev. 781 (1992), reprinted in 93 TNT 112-36 (May 26, 1993).

The factual/interpretive distinction is also discussed in the literature on the law of evidence. See, e.g., Arthur R. Miller, *Federal Rule 44.1 and the “Fact” Approach to Determining Foreign Law: Death Knell for a Die-Hard Doctrine*, 65 Mich. L. Rev. 613 (1967). More generally, it may be thought of as an elaboration, in a narrow context, of choice of law principles. There is an enormous body of literature on choice of law, and discussion of that literature is beyond the scope of this article. For discussion of these principles in the U.S. context, see, e.g., Brainerd Currie, *Selected Essays on the Conflict of Laws* (1963); Russell J. Weintraub, *Commentary on the Conflict of Laws* (3d ed. 1986); Walter W. Cook, *The Logical and Legal Bases of the Conflict of Laws*, 33 Yale L.J. 457 (1924); Arthur R. Von Mehren, *Special Substantive Rules for Multistate Problems: Their Role and Significance in Contemporary Choice of Law Methodology*, 88 Harv. L. Rev. 347 (1974).

foreign law. This view would seem to be noncontroversial. Indeed, there is scant criticism of the *Biddle* holding or *ratio decidendi* in the literature.²⁸ As will be seen, however, *Biddle* has been interpreted more broadly.

2. *The Regulations.*—The regulations implementing the *Biddle* decision state that a tax is considered paid for purposes of section 901 by the person on whom foreign law imposes legal liability for the tax.²⁹ Thus, even if another party to a transaction with the taxpayer assumes liability for foreign taxes on income generated in the transaction, only the person legally liable for the tax, and not that other party, is entitled to a credit for such foreign taxes. The economic burden of the tax is also irrelevant.

By making the credit's availability depend on formalistic legal liability,³⁰ the Treasury may cause section 901 to be applied both too broadly and too narrowly. Too broadly because the credit may be available in circumstances that violate the tax policy principle that the tax consequences of a transaction should be based on its economic substance.³¹ Too narrowly because, in certain cases, the legal liability standard makes the availability of the credit too uncertain, violating a second tax policy principle: To the extent possible, taxpayers should have certainty regarding the tax consequences of their transactions.³²

The legal liability test can violate both principles when applied to net loans. In a net loan, the borrower is required to pay interest free and clear of

28. But see Charles I. Kingson, *The Foreign Tax Credit and Its Critics*, 9 Am. J. Tax Pol'y 1, n. 147 (1991) [hereinafter Kingson, *Foreign Tax Credit*]. One might also infer such criticism from the failure of the *Continental Illinois* court to cite *Biddle*. See *Continental Ill. Corp. v. Commissioner*, 998 F.2d 513 (7th Cir. 1993), cert. denied, 114 S. Ct. 685 (1994).

29. Regs. § 1.901-2(f)(1).

30. This formalistic approach may be considered administratively desirable because, in many cases, it should be easier to determine legal liability than to make a factual determination of economic burden. For a similar reliance on a formalistic application of foreign law, see Prop. Regs. § 301.7701-3(b)(2) (classifying a foreign "eligible entity" that does not elect a particular classification, based in part on formalistic application of foreign law regarding liability for claims against the entity).

31. See *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978); *Knetsch v. United States*, 364 U.S. 361, 365-69 (1960); *Gregory v. Helvering*, 293 U.S. 465, 470 (1935); *Goldstein v. Commissioner*, 364 F.2d 734, 740 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967).

32. Formalistic dependence of the credit on legal liability can result in uncertainty because foreign law regarding legal liability is sometimes unclear. Moreover, if the IRS declines to apply the legal liability standard in cases where there is suspicion of taxpayer/foreign government collusion, it is uncertain whether even a clear foreign statute is dispositive. For a recent case well illustrating these difficulties in an analogous foreign tax credit context, see *Amoco v. Commissioner*, 71 T.C. Memo (CCH) 2613, ¶ 96,159 T.C. Memo (RIA) (1996).

any withholding tax. Thus, if a net loan of \$100 bears interest at 10%, the borrower will pay the lender \$10 of interest each year and will, in addition, pay to the taxing authority any withholding tax on the interest.³³ Conversely, in a gross loan, the borrower deducts any withholding tax from the stated interest, pays the tax to the taxing jurisdiction, and pays the difference to the lender.³⁴

From a policy perspective, it is at least arguable that the lender in a net loan pays no foreign tax and should therefore be entitled to no foreign tax credit. An analysis based on the economic burden of the tax could easily lead to this result. Instead, however, the IRS has struggled unsuccessfully to establish that foreign law imposes legal liability on the borrower, rather than the lender.³⁵ In at least one case, the IRS ruled that the lender in a net loan was legally liable for a foreign tax, only to later reexamine the foreign law and take a contrary position.³⁶

This situation is unsatisfactory for both tax administrators and taxpayers. Practitioners have found that the IRS is sometimes reluctant to rule on the question of legal liability.³⁷ This reluctance is ostensibly due to ambiguity in some foreign laws, but it may also be due, in part, to IRS uneasiness with the formalistic legal liability standard.³⁸

In light of this unsatisfactory state of affairs brought about by a restrictive set of regulations, the question arises whether the authors of the regulations might have based them on an unnecessarily broad interpretation of *Biddle*. As indicated above, the regulations have implicitly interpreted *Biddle* to preclude the application of the substance over form doctrine. Nothing in the *Biddle* opinion requires this result. Application of the substance over form doctrine could easily have been harmonized with *Biddle*. The regulations could have rejected an interpretive use of foreign law, as the

33. To calculate the withholding tax, simultaneous equations are required. See Harvey P. Dale, *Withholding Tax on Payments to Foreign Persons*, 36 *Tax L. Rev.* 49, 90-91 (1980).

34. In a gross loan, the lender typically seeks additional interest from the borrower to compensate for the return on its investment that is lost to the taxing jurisdiction. Thus, the after-tax cost to the borrower is likely to be the same.

35. *Norwest Corp. v. Commissioner*, 69 F.3d 1404 (8th Cir. 1995); *Continental Ill. Corp. v. Commissioner*, 998 F.2d 513 (7th Cir. 1993), cert. denied, 114 S. Ct. 685 (1994); *Nissho Iwai American Corp. v. Commissioner*, 89 T.C. 765 (1987).

36. See Rev. Rul. 78-258, 1978-1 C.B. 239, modified, Rev. Rul. 89-119 1989-2 C.B. 132.

37. Although the IRS is not required to issue rulings, its policy is to respond to inquiries regarding the tax effect of transactions prior to the filing of a tax return whenever this is in the interest of sound tax administration. See Regs. § 601.201(a)(1).

38. This conclusion derives from the fact that the IRS has been reluctant to rule, even with the customary caveats that the ruling is conditioned on the completeness and accuracy of the facts and translations of foreign law provided by the taxpayer.

Court did in *Biddle*, yet not required a formalistic application of the legal liability standard that can produce inappropriate results and create unnecessary uncertainty for taxpayers.

B. *Indirect Credit*

1. *Goodyear*.—A recent case, *United States v. Goodyear Tire & Rubber Co.*,³⁹ provided the Supreme Court with an opportunity to revisit the propriety of interpretive uses of foreign law. In *Goodyear*, the Court construed section 902, which provides that taxes paid by a foreign corporation may be creditable by the corporation's U.S. shareholders when the earnings upon which those taxes were levied are distributed to the shareholders. This credit, commonly referred to as the indirect credit, is only allowed to a domestic corporation that owns at least 10% of a foreign corporation's voting stock and receives a dividend from the corporation.⁴⁰ It is intended to ensure that only one layer of U.S. tax is imposed on earnings of a domestic corporation that are earned through a foreign subsidiary.⁴¹

The indirect credit under section 902 equals the portion of foreign corporation's foreign income taxes that is ratably allocable to the earnings distributed to the domestic corporation as a dividend. During the years at issue in *Goodyear*, the indirect credit was computed as the foreign income taxes for the year that the corporation realized the distributed earnings, multiplied by the following fraction:

$$\frac{\text{Dividend}}{\text{After-tax accumulated profits for that year}}$$

The issue in *Goodyear* was whether the term "accumulated profits" should be construed to mean U.S. taxable income or taxable income under the applicable foreign (U.K.) law. As a result of an operating loss carryback, the U.K. tax liability of Goodyear's U.K. subsidiary was reduced for the taxable year involved in the case. *Goodyear* contended that since the carryback

39. 493 U.S. 132 (1989).

40. IRC §§ 902(a). Other rules allow the credit where earnings are taxed to such a shareholder without being distributed. IRC §§ 960, 1291(g).

41. If a domestic corporation operates through a foreign branch, foreign taxes on branch income are creditable under § 901, the statute whose predecessor was at issue in *Biddle*. Section 902 provides roughly equivalent tax results to a domestic corporation operating through a foreign subsidiary. Interestingly, had the taxpayer in *Biddle* been a 10% corporate shareholder of the U.K. corporation involved in that case, rather than an individual, the predecessor of § 902 would have allowed the credits the Court denied under the predecessor of § 901. See Revenue Act of 1918, § 240(c).

reduced the subsidiary's foreign taxes, it should also reduce the subsidiary's "accumulated profits."⁴²

The Court resolved the issue by analyzing the purposes of section 902: to eliminate double taxation and to equate the taxation of foreign operations conducted through subsidiaries with the taxation of operations conducted through branches. Double taxation can result if accumulated profits are computed solely with reference to U.S. principles.⁴³ This militates against a reading of section 902 that allows a foreign corporation's "accumulated profits" to differ from taxable earnings under foreign law. On the other hand, because the income of a foreign branch is computed under U.S. tax rules, foreign branch income and foreign subsidiary income would be taxed unequally if the accumulated profits of a foreign subsidiary were computed

42. The effects of the differing computations of accumulated profits is illustrated by the following chart. In Scenario 1, accumulated profits are not reduced to reflect the reduction in foreign taxable income. In Scenario 2, accumulated profits are so reduced.

	Foreign Taxes Paid	Dividend	After-Tax Accumulated Profits	Creditable Taxes
Scenario 1	\$100	\$900	\$1,800	\$50
Scenario 2	\$100	\$900	\$900	\$100

43. Under the pre-1987 rules involved in *Goodyear*, a dividend is traced to the accumulated profits of a particular year, and the indirect tax credit is only allowed for taxes paid with respect to the accumulated profits for that year. See IRC § 902(a) (before amendment in 1986); Reg. § 1.902-1(f); Rev. Rul. 87-72, 1987-2 C.B. 170. In *Goodyear*, the subsidiary's operating loss carryback under U.K. law reduced U.K. taxes for the taxable years to zero, but because accumulated profits, defined by U.S. law, were not affected by the carryback, the dividends continued to be traced to these years' earnings and thus carried no indirect credit. The result is not necessarily double taxation because the foreign corporation may distribute other dividends that are traced to years for which foreign income taxes are paid by the corporation and the U.S. shareholder might therefore ultimately be allowed credit for all taxes paid by the foreign corporation.

The double taxation can be more obvious in the opposite situation. If accumulated profits for a particular year are zero under the U.S. rules, but the foreign corporation nevertheless pays foreign income taxes for the year (e.g., because accumulated profits are reduced under rules that do not apply under the foreign tax law), a dividend can never be traced to accumulated profits for that year, and it is thus impossible for the foreign income taxes to be creditable to the U.S. shareholder. If the income taxed by the foreign country for this year is recognized under U.S. principles for another year, the income may be taxed to the U.S. shareholder when dividends are distributed from accumulated profits for that other year, and the result may be double taxation. See Kingson, *Foreign Tax Credit*, supra note 28, at 36-37.

These problems are lessened for post-1986 years because dividends are drawn from a pool of accumulated profits, rather than earnings of one year, thus minimizing such artificial disparities between tax years. See IRC § 902(a).

under foreign law. This militates against a reading of section 902 that requires a foreign corporation's "accumulated profits" to be computed in accordance with its taxable earnings under foreign law. The Court found more compelling the policy that branches and subsidiaries should be taxed equally.

Although the reasoning is not particularly persuasive,⁴⁴ the Court undoubtedly reached the correct result. "Accumulated profits" is one element of a fraction whose function is to determine the part of the foreign taxes that should be credited to a particular shareholder. Since the fraction's numerator (dividends) is always computed with reference to U.S. tax principles,⁴⁵ the denominator (after-tax accumulated profits) must also be computed under U.S. tax principles. For example, if all of a year's profits are paid to one shareholder, the numerator and the denominator should be equal, a condition that is possible only if both figures are computed under the same rules.

From one perspective, *Goodyear* presents an even stronger case for the rejection of foreign law than *Biddle*. *Biddle* presented two questions: What does the word "paid" mean? Did the taxpayer satisfy this definition? The Court declined to use foreign law in answering the first question (doing so would have been an interpretive use of foreign law), but it was willing to answer the second question with reference to foreign law (doing so was a factual use of foreign law). *Goodyear* involved only one question, a pure question of law, requiring only an interpretive and not a factual use of foreign law.

However, a distinction might be drawn between *Biddle* and *Goodyear* that would allow the *Goodyear* issue to be addressed with greater flexibility in the use of foreign law than the *Biddle* issue. The *Biddle* Court was asked

44. Inconsistencies in the calculation of branch and subsidiary profits are not necessarily the type of inconsistency that offends the policy behind § 902. This policy would be offended if the tax liabilities incurred in operating through a foreign subsidiary were inconsistent with those that would result from carrying on the same operations through a foreign branch. The tax liabilities resulting from branch and subsidiary operating structures would not necessarily be inconsistent simply because profits are calculated differently. Consistency of tax liabilities would depend on whether branch profits and subsidiary profits play the same role in determining the foreign tax credit of the U.S. corporate parent. As a general rule, they do not. In the case of subsidiary profits, the higher the profits the lower the amount of the foreign taxes paid that will be available as a credit under § 902, other things being equal. See *supra* note 42. In the case of a foreign branch, the amount of the branch's taxable profits is irrelevant to the amount of credits available to the U.S. corporation under § 901. Although such profits are relevant to the calculation of the foreign tax credit limitation under § 904, the limitation applies to credits for foreign taxes of both branches and subsidiaries and therefore does not affect this analysis of the differences between the two. For a discussion of the sometimes troubling distinction between branch and subsidiary, see Diane Ring, *Treatment of Risk Shifting, Common Ownership and Legal Status in Related Party Transactions* (July 30, 1995) (unpublished draft on file with the *Florida Tax Review*).

45. See IRC § 316(a).

to define a term ("paid") by looking to the foreign law definition of the term. In *Goodyear*, the Court was not asked to apply a foreign law definition (the term "accumulated profits" was not defined in U.K. law), but to adopt a U.S. definition of a U.S. term that would depend on the way in which the foreign taxes were computed.⁴⁶ *Biddle* thus did not compel the result in *Goodyear*, and the *Goodyear* Court's rejection of an interpretive use of foreign law was not as critical as *Biddle*'s.

In sum, the *Goodyear* issue, viewed from one perspective, calls for a rejection of the application of foreign law even more clearly than the *Biddle* issue, but viewed from another perspective, the *Goodyear* issue leaves greater room for the application of foreign law. If the former perspective is correct, it may be difficult to justify the decision in *Vulcan Materials*⁴⁷ (discussed immediately below), another case that involved the *Goodyear* issue (or a closely related issue), but reached the opposite result. Conversely, if *Goodyear* allows greater room for the application of foreign law than *Biddle*, or if, as Judge Tannenwald believed, *Vulcan Materials* involved an issue distinct from that in *Goodyear*, an issue that required only a factual use of foreign law, a result opposite to *Goodyear*'s may be justifiable. With these perspectives in mind, we turn to the *Vulcan Materials* case.

2. *Vulcan Materials*.—In *Vulcan Materials*, the taxpayer argued that, for purposes of the indirect credit, the accumulated profits of a Saudi Arabian corporation (TVCL) should be lower than that asserted by the IRS because Saudi Arabian law imposed tax only on the profits attributable to Vulcan's stock in TVCL and not on the profits attributable to the stock owned by TVCL's Saudi Arabian shareholders. In response to the IRS' argument that the case was controlled by *Goodyear*, Judge Tannenwald stated:

There is no question that, under *Goodyear*, the determination of TVCL's accumulated profits turns upon the application of U.S. tax rules, and petitioner does not contend otherwise. The question before us is not how TVCL's accumulated profits are to be determined but whether, pursuant to section 902, all or only a pro rata portion of such profits so determined are to be included in the denominator of the formula.⁴⁸

46. By failing to cite *Biddle* until a brief reference at the end of the opinion, *Goodyear* implicitly recognized that *Biddle* only stood for a limited rule of statutory construction. *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132, 145 (1989).

47. *Vulcan Materials Co. v. Commissioner*, 96 T.C. 410 (1991), *aff'd per curiam*, 959 F.2d 973 (11th Cir. 1992), nonacq. 1995-1 C.B. 1.

48. *Id.* at 417. After dismissing the notion that the issue in the case was resolved by *Goodyear*, Judge Tannenwald stated:

To the IRS, this distinction is too subtle.⁴⁹ But in none of its attacks on *Vulcan Materials* is a standard proposed for distinguishing legitimate uses of foreign law from illegitimate uses of foreign law. In explaining its non-acquiescence in the decision, the IRS both oversimplifies and overstates the *Goodyear* holding: "The Tax Court decision conflicts with the rule clearly articulated in *Goodyear* that the determination of the section 902 fraction is . . . computed in accordance with United States tax principles, and not on foreign taxable income."⁵⁰

The *Vulcan Materials* opinion does not explicate a principled approach to the use of foreign law. Therefore, to analyze whether *Vulcan Materials* violates the principles concerning the use of foreign law that can be gleaned from *Biddle* and *Goodyear*, we should ask: Is there a principled basis for taking foreign law into account in interpreting the phrase "accumulated profits," and if so, was this basis appropriately used by the *Vulcan Materials* court? It is this author's view that such a principled basis does exist and was appropriately used by the *Vulcan Materials* court. However, the IRS has legitimate concerns regarding the potential for abuse that led it to read *Goodyear* as applying broadly, and because of those concerns, it is reasonable to promulgate regulations reversing the result in *Vulcan Materials*.⁵¹

In short, *Vulcan Materials* involved a factual use of Saudi Arabian law, although the point is more subtle in the context of this case than in the

The long and the short of the matter is that "no definitional approach to 'accumulated profits' uniformly and unqualifiedly satisfies the dual purposes underlying the indirect credit." See *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. at [143]. Such being the case, the question before us is which interpretation of that term as discussed by the parties herein "is more faithful to congressional intent." 493 U.S. at [143]. Our view is that petitioner's interpretation of the phrase "accumulated profits," rather than that of respondent, best carries out that intent. We so hold.

Id. at 421.

49. See Prop. Regs. §§ 1.902-1(a)(9)(iv), - 1(a)(10)(ii) (proposing to reverse the decision in *Vulcan Materials* to the extent the issue remains relevant); Action on Decision CC-1995-002 (Feb. 13, 1995), available in LEXIS, FEDTAX library, RELS file (explaining IRS decision not to acquiesce in the *Vulcan Materials* decision).

50. Action on Decision CC-1995-002, *supra* note 49.

51. Ironically, the dispute in *Vulcan Materials* might never have arisen if an economic substance approach to the credit had been adopted by the regulations. Under such an approach, *Vulcan* would have been able to argue that only its allocable share of TVCL's earnings economically bore the burden of the foreign tax and, therefore, only its allocable share of TVCL's accumulated profits should be considered under § 902. In effect, as described below, Judge Tannenwald accepted an economic substance approach, and perhaps *Vulcan Materials* can best be reconciled with *Goodyear* on that basis. In both cases, the courts ensured that the taxpayers were able to claim appropriate credits for the foreign taxes imposed on the income they indirectly earned.

cases discussed above. Viewed from Judge Tannenwald's perspective, foreign law was not being invoked to provide a rule of decision; *Goodyear* would have precluded any such use.⁵² Rather, foreign law was, in effect, being used factually to support a *sub silentio* substance over form approach to the case.⁵³ In essence, the court approached the case by determining, under U.S. tax principles, what the corporation's accumulated profits were, and then looking to foreign law for the factual determination of whether, in substance, the corporation had an obligation to make a payment (in this case, a pretax set-aside of a proportionate share of profits) to a third-party (in this case, the Saudi shareholder) that would, like a royalty payment, reduce the corporation's accumulated profits even under U.S. tax principles.

Admittedly, this theory is not stated in the opinion. Moreover, the approach may be viewed as tying the term "accumulated profits" more to the "foreign taxes paid" term of the § 902 equation than to the "dividend" term, in apparent violation of the underpinnings of *Goodyear*. It is submitted, however, that the use to which foreign law is put in *Vulcan Materials* is more factual than the use of foreign law sought by the taxpayer in *Goodyear*. As such, a basis may exist for reconciling the two cases.

Adoption of the *Vulcan Materials* result in all cases could, however, open the door to collusion between taxpayers and foreign governments to increase indirect foreign tax credits. The IRS thus has a legitimate concern over the *Vulcan Materials* result. For this reason, and because reconciling *Vulcan Materials* and *Goodyear* requires significant effort, it is fully appropriate for the IRS to reverse the result in *Vulcan Materials* by finalizing its proposed regulations on this point.⁵⁴

C. Definition of "Income Tax"

Under section 901, taxpayers may elect to claim a credit for foreign income taxes. Under section 903, the credit also lies for foreign taxes imposed "in lieu of" income taxes. In both cases, the foreign levy must be a tax.

Foreign governments may deal with U.S. taxpayers as sovereigns, proprietors, or both.⁵⁵ Therefore, U.S. taxpayers may make payments to foreign governments that are taxes, contract payments, or both. Since the credit lies only for taxes, the Treasury must sort out which of these payments are taxes and which are not, often hindered, not helped, by the labels attached to the payments by the foreign government.

52. See *Vulcan Materials*, 96 T.C. at 417 ("There is no question that, under *Goodyear*, the determination of TVCL's accumulated profits turns upon the application of U.S. tax rules . . .").

53. Cf. *Vulcan Materials*, 96 T.C. at 419.

54. Prop. Regs. §§ 1.902-1(a)(9)(iv), - 1(a)(10)(ii).

55. See Isenbergh, *supra* note 1, at 228.

As was pointed out over 10 years ago:

Foreign precepts of . . . tax administration, and notions of income differ notably from our own. How much a foreign tax system can differ from ours in its structure and practical effect and still give rise to creditable income taxes has been a matter of dispute virtually since the credit was introduced.⁵⁶

To address these concerns, the Treasury issued, after numerous iterations, detailed regulations distinguishing taxes from noncreditable payments to foreign governments and distinguishing creditable foreign taxes on income from other types of taxes.⁵⁷ Shortly after the regulations were issued in 1983, it was predicted that they would lead to enormous complexities of application and questionable results.⁵⁸ Therefore, it was suggested, the attempt to distinguish taxes from royalties paid to foreign governments should essentially be abandoned.⁵⁹ However, the regulations, although complex, are no more complex than many other regulations issued during and since 1983.⁶⁰ Moreover, there do not appear to have been many disputes

56. *Id.* at 227.

57. See Regs. §§ 1.901-2, -2A, 1.903-1, 48 Fed. Reg. 46,272 (1983); Prop. Regs. §§ 1.901-2, -2A, 1.903-1, 48 Fed. Reg. 14,641 (1983) (proposed Apr. 5, 1983); Temp. & Prop. Regs. §§ 1.901-2, 1.903-1, 45 Fed. Reg. 75,695 (1980); Prop. Regs. §§ 1.901-2, 1.903-1, 44 Fed. Reg. 36,071 (1979) (proposed June 22, 1979). Amendments to § 1.901-2(e)(3) were proposed on November 15, 1988 and finalized on October 31, 1991. See 53 Fed. Reg. 45,942 (1988); 56 Fed. Reg. 56,007 (1991).

58. Isenbergh, *supra* note 1, at 229.

59. *Id.* It was suggested that this proposal be wedded to a repeal of the deferral privilege, which (subject to large exceptions in subpart F and other provisions) allows U.S. taxation of earnings of U.S.-owned foreign corporations to await the distribution of the earnings as dividends. The apparent basis for this marriage was that the revenue gain posited from the repeal of deferral could offset the revenue loss resulting from liberalization of the credit. Recent analysis, however, suggests that a repeal of deferral might not raise significant tax revenues, and could even be a net revenue loser, because (1) most foreign earnings would carry foreign tax credits when included in U.S. shareholders' income and (2) U.S. taxable income would be reduced by the allowance of formerly deferred losses. See, e.g., Treasury Dep't Study, *International Tax Reform: An Interim Report* 50 (Jan. 15, 1993), in *Tax'n, Budget & Account. Text (BNA) No. 13*, at L-1 (Jan. 22, 1993).

60. For example, within the context of the foreign tax credit, the complexity of these regulations has been equaled, if not exceeded, by regulations under the separate limitation rules of § 904(d). See Regs. §§ 1.904-4 to -7 (issued in 1988). In a closely related context, regulatory developments under subpart F continue to dazzle and amaze tax practitioners. See Regs. §§ 1.954-1, -2 (issued in 1995). Outside the area of international taxation, the examples of highly complex regulations issued over the last 10 years are almost too numerous to list. See, e.g., Regs. §§ 1.469-1 to -11 (passive activity losses); 1.704-1 to -3 (partnership allocations); 1.1271-1 to -6 (original issue discount).

over the regulations' application.⁶¹ Simplification of these regulations thus would not materially simplify the tax landscape.

Perhaps most importantly, there are significant tax policy reasons why the credit should only be allowed for foreign taxes and not for other payments to foreign governments.⁶² The purpose of the foreign tax credit is to prevent double taxation. To achieve this purpose, the law must identify the fiscal burdens that would create double taxation and provide relief from those burdens. If the relief is not restricted to tax burdens, nontax expenditures will be elevated from deductible payments to creditable payments without any substantive policy reason for doing so.

Moreover, the regulations, while looking to foreign law, require only a factual use of foreign law. They are quite detailed with respect to the standards to be used in determining whether a foreign levy is an income tax in the U.S. sense. Foreign law is only considered to determine whether these standards of U.S. tax law have been satisfied.

Because there is a strong tax policy to restrict the credit to foreign taxes, because foreign law is used for these purposes in a principled manner under the standards advocated in this article, and because the ostensible objectives of simplification and the prevention of questionable results do not appear to be materially furthered by eliminating the distinction between foreign taxes and foreign nontax payments, we must ask what greater good would be served by eliminating this distinction. It appears that the argument comes down to this: The job of defining a "tax" is too difficult.⁶³ It is this author's view that, with a good working definition of a "tax" such as the regulations provide, and a principled use of foreign law to inform that definition, the policy stakes are too high to justify a response of "it's too difficult."⁶⁴

61. Isenbergh does not identify the questionable results he predicts. If inappropriate results were identified, Isenbergh would have a substantive basis for objecting to the rules, rather than an administrative basis, such as avoiding complexity. A substantive objection, unless overridden by countervailing substantive or administrative concerns, such as the desire to avoid even greater complexity, would have to be seriously considered. Substantive objections may, however, still emerge because cases testing the regulations may not yet have reached the point of litigation. For example, a recently decided case on the creditability of a Norwegian petroleum levy involved the tax years 1981 and 1982, which predate the present regulations. See *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995).

62. Isenbergh acknowledges the importance of these concerns by his reservation that the tax/nontax distinction should be retained in "the most transparent cases." Isenbergh, *supra* note 1, at 229.

63. See *id.* at 229 ("These proposals derive much of their force from the difficulties of setting the boundaries of creditable taxes under present law").

64. This is not to say that the regulatory definition of a tax is perfect. The author understands that some foreign governments have made compelling cases that their taxes are excluded from U.S. creditability due to an overly narrow definition of what is a tax on income

D. Intercompany Transfer Pricing

Section 482 gives the IRS authority to reallocate income among commonly controlled businesses if necessary to prevent tax evasion or to reflect clearly the income of such organizations.⁶⁵ A reallocation is appropriate if the terms of transactions among commonly controlled businesses differ from those that would have been agreed upon by unrelated persons dealing at arm's length.⁶⁶

Suppose a legal restriction makes it unlawful for a member of a controlled group of taxpayers to realize the income that the member would have had if it dealt at arm's length with an unrelated person and the legal restriction did not apply. Can the IRS nevertheless require under section 482 that the member recognize the arm's length amount of income? This question was first presented to the courts in the context of a domestic legal restriction. In the *First Security Bank* case, the Supreme Court barred the IRS from allocating insurance premiums from an insurance agency to its bank affiliate because the bank was precluded under the National Bank Act from serving as an insurance agent.⁶⁷

More recently, the courts have considered whether this principle applies in the context of a foreign legal restriction. In the *Procter & Gamble* case, the taxpayer had a Spanish subsidiary that, under the laws of Spain, was precluded from paying royalties or technical assistance fees.⁶⁸ Both the Tax Court and the Sixth Circuit rejected the government's argument that *First*

or a tax in lieu of a tax on income. But when the policy reasons for restricting the credit to foreign taxes are so clear, and there are such meager principled objections to the present method of achieving this restriction, such problems should be solved by refining the definition, not by the curious expedient of throwing up our hands and abandoning the restriction altogether.

65. Section 482 provides, in pertinent part:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

66. See Regs. § 1.482-1(a)(1).

67. *Commissioner v. First Security Bank*, 405 U.S. 394 (1972). See *Tower Loan v. Commissioner*, 71 T.C. Memo (CCH) 2581, T.C. Memo (RIA) ¶ 96,152 (1996) (following *First Security* in case involving credit life insurance premiums paid to insurance subsidiary of consumer loan company that was barred by state law from receiving such premiums).

68. *Procter & Gamble Co. v. Commissioner*, 95 T.C. 323, 325 (1990), aff'd, 961 F.2d 1255 (6th Cir. 1992).

Security could be distinguished because it involved a domestic, not a foreign statute. They reasoned that section 482 allows the IRS to reallocate income where the taxpayer's income is distorted by virtue of the fact that it is a member of a controlled group. Where the distortion arises from (or cannot be corrected because of) a governmental restriction, reallocation is inappropriate, whether the restriction is contained in foreign law or domestic law.⁶⁹

In the Tax Court, the IRS moved for reconsideration of the *Procter & Gamble* decision, citing *Goodyear* for the proposition that "tax provisions should generally be read to incorporate domestic tax concepts absent a clear congressional expression that foreign concepts control."⁷⁰ In ruling on the motion, the Tax Court, although not expressly relying on the interpretive/factual distinction advocated here, made precisely that distinction in substance, responding that its ruling was premised upon a U.S. tax concept (reallocation is inappropriate when receipt of the income at issue is prohibited by law) that made relevant the fact of the foreign legal restriction.⁷¹ The use of foreign law as a fact was perfectly acceptable to the court, as long as the court used a U.S. rule of decision.

The IRS mounted a strenuous attack on this line of authority in one of the largest cases ever to come before the Tax Court, the *Exxon* case,⁷² which dealt with a Saudi government-mandated reduction in crude oil prices paid by Exxon, Chevron, Texaco, and Mobil for Saudi oil.⁷³ In brief, these four American companies, through foreign affiliates (offtakers), acquired significant amounts of crude oil from Saudi Arabia at prices below the market prices charged by other oil producing nations.⁷⁴ The Saudi government wanted the benefit of these lower prices (the Aramco Advantage) to be passed on to consumers. It attempted to do so by requiring the oftakers to sell the crude to refineries at a low price reflecting the Saudi discount. The

69. 95 T.C. at 339; 961 F.2d at 1259-60.

70. *Procter & Gamble Co. v. Commissioner*, 60 T.C. Memo (CCH) 1463, 1466, T.C. Memo (P-H) ¶ 90,638, at 3114-90 (1990), aff'd, 961 F.2d 1255 (6th Cir. 1992).

71. *Id.*

72. *Exxon Corp. v. Commissioner*, 66 T.C. Memo (CCH) 1707, T.C. Memo (RIA) ¶ 93,616 (1993). These consolidated cases were believed to involve a deficiency exceeding \$8 billion, the largest in the Tax Court's history. See Karen Matthews, *Progress Slow As \$8 Billion 'Aramco Advantage' Trial Begins*, 91 *TNI* 15-4 (Apr. 10, 1991) (LEXIS, FEDTAX library, TAXTXT file). A companion case involving *Texaco, Inc.*, is on appeal to the Court of Appeals for the Fifth Circuit. An appeal in the *Exxon* case will lie in the Second Circuit.

73. Aramco was a joint venture owned by these four companies. *Exxon Corp.*, 66 T.C. Memo (CCH) at 1709, T.C. Memo (RIA) at 93-3230.

74. The discrepancy arose because, during the oil crisis of the late 1970s, Saudi Arabia did not raise prices as dramatically as did other members of the Organization of Petroleum Exporting Countries (OPEC). *Id.* 66 T.C. Memo (CCH) at 1714-15, T.C. Memo (RIA) at 93-3236.

Saudi government could not, however, ensure that the prices paid by purchasers from the refineries also reflected the Aramco Advantage. Thus, the refineries buying from the offtakers bought at prices reflecting the Aramco Advantage and sold at the normal market prices, allowing them to capture the Advantage.

In many cases, the refineries and offtakers were controlled by the same oil companies. The IRS took the position that, in these controlled sales from offtakers to refineries, section 482 authorized it to restate the sales prices at market, notwithstanding the requirement of Saudi law that the offtakers sell at below-market prices.⁷⁵ In support of this position, the IRS made several arguments, including: (1) Because foreign law is difficult to ascertain, the court erred when, in *Procter & Gamble*, it extended *First Security Bank* to foreign law situations, and (2) to allow foreign law to control the consequences in *Exxon* would be to allow foreign law to dictate U.S. tax law and policy.⁷⁶

Regarding the first argument, the court agreed that a heightened scrutiny of the evidence might be required in the case of a foreign legal restriction, in part because the taxpayer might have had a role in the promulgation of the restriction. The court did not go so far as to hold, however, that the need for heightened scrutiny should preclude the application of the *First Security* principle.

Although foreign law may be difficult to ascertain (mere translation of statutory language may fail to convey the full meaning of a statutory provision), the question is not whether foreign law is difficult to ascertain, but whether, in a particular circumstance, the tax law should devote the resources necessary to ascertain foreign law. As discussed above in Part II.A.2, the necessity for ascertaining foreign law could have been avoided in many cases if the Treasury had adopted an economic substance approach to determining who may claim the foreign tax credit. Apparently convinced that, in those cases, the tax law must devote the resources necessary to ascertain foreign

75. *Exxon Corp.*, 66 T.C. Memo (CCH) at 1733, T.C. Memo (RIA) at 93-3256. Presumably, the effect of the IRS' proposed adjustment was to shift revenue from the refineries, with substantial costs and deductions reducing taxable income, to the offtakers, with considerably fewer costs and deductions. This would increase the earnings and profits and subpart F income of the group, increasing its U.S. tax liability. See IRC §§ 312, 952(c), 964(a).

76. *Exxon Corp.*, 66 T.C. Memo (CCH) at 1737, T.C. Memo (RIA) at 93-3261. The IRS' other arguments included: (1) *Procter & Gamble* is distinguishable because, in that case, the foreign law was embodied in a formal statutory provision whereas, in *Exxon*, there was only a series of memoranda and letters from government officials, and (2) *Procter & Gamble* was incorrectly decided because the legislative history of § 482 does not refer to foreign law and, therefore, foreign law should not affect allocations under § 482. These arguments were dismissed by the Court. *Id.* 66 T.C. Memo (CCH) at 1736-37, T.C. Memo (RIA) at 93-3260.

law, it seems anomalous that the government argues against the relevance of foreign law under section 482.⁷⁷

Arguably, the results should be reversed. Where there is an alternative to relying on foreign law (e.g., reading *Biddle* more narrowly to allow for the application of the substance over form doctrine in ascertaining the payor of a foreign tax, thus obviating the need to determine legal liability for the tax), arguably, the alternative should be pursued before the sometimes murky waters of foreign law are entered. Where, however, the application of a statute may require that foreign law be established as a fact, such as is the case under section 482,⁷⁸ foreign law arguably should be taken into account.

Regarding the IRS' second argument—a taxpayer victory would allow foreign law to dictate U.S. tax consequences—the *Exxon* court stated:

While foreign law may be relevant for purposes of determining whether a legal prohibition exists and, ultimately, . . . whether section 482 is applicable in a particular instance, such determinations are made in accordance with, and in furtherance of, the Supreme Court's decision in *First Security*. Consequently, we look to foreign law as a means of implementing U.S. law, not as a means of usurping it.⁷⁹

It is thus evident that the *Exxon* court, like the others discussed above, distinguished between interpretive and factual uses of foreign law. If the court were to have ceded a U.S. law determination to a foreign government, as the government said it would be doing if it ruled for the taxpayer, it would have made an interpretive use of foreign law. The court did not, however, do so. It did not interpret U.S. statutory language as that language is interpreted under the laws of a foreign jurisdiction. Instead, the court put foreign law to a factual use, as did the courts in *Biddle*, *Vulcan Materials*, and *Procter & Gamble*.⁸⁰

77. The government did not expressly argue in *Exxon* that foreign law should never be taken into account under § 482, but this is the logical extension of its argument that foreign law should not be taken into account because it is inherently unreliable.

78. As noted above, before § 482 can apply, it must be established that a nonmarket price results from the fact that the taxpayers are under common control and not from other facts, such as bona fide foreign legal restrictions. See *supra* text accompanying note 69.

79. *Exxon Corp.*, 66 T.C. Memo (CCH) at 1738, T.C. Memo (RIA) at 93-3261 (footnote omitted).

80. Under the 1968 regulations, when payments between affiliates were prevented "because of currency or other restrictions imposed under the laws of any foreign country," adjustments under § 482 could be treated as deferrable income or deductions if this treatment was consistent with the taxpayer's accounting method. Regs. § 1.482-1(d)(6) (before amendment in 1994). Thus, the Treasury applied a deferral approach to situations involving foreign restrictions on payments, rather than completely exempting restricted payments from

III. CROSS-BORDER TAX ARBITRAGE

Jurisdictions often differ in their tax treatments of particular transactions or items. The tax treatments are sometimes so different as to be inconsistent. Where this inconsistent treatment produces tax benefits that would not be available if the transaction or item were treated consistently, it may be referred to as cross-border tax arbitrage.

Foreign law generally plays a different role in cross-border tax arbitrage transactions than it does in the situations discussed above. In tax arbitrage situations, foreign law generally has no direct impact on U.S. tax consequences, either as a prescriptive rule of decision or as a fact tending to satisfy a condition precedent to the application of a statutory rule.⁸¹ Rather, foreign law is most often implicated solely because the inconsistent treatment, by creating tax benefits in two jurisdictions, each predicated on a view of the facts or a legal characterization fundamentally at odds with the other, raises tax policy concerns.

Under one view of this tax policy issue, U.S. tax officials can have no legitimate objection to this sort of tax arbitrage.⁸² Because neither jurisdiction's law is dependent on, or even relevant to the other, the concerns raised above regarding the use of foreign law are not implicated. That is, tax arbitrage situations are not a U.S. tax policy concern because there is no extraterritorial relevance to the law of either jurisdiction, only the fortuitous anomaly that the tax result in each jurisdiction is predicated upon a view of

the application of § 482 under the principles of *First Security Bank*. See, e.g., Rev. Rul. 74-24, 1974-1 C.B. 124 (conditioning suspension of current adjustments on taxpayer's election of an accounting method that deferred recognition of income). This alternative to applying *First Security Bank* in the foreign context addressed a concern about collusion between taxpayers and foreign governments: To the extent a foreign government has an interest in restricting deductible payments and a taxpayer benefits from the resulting offshore accumulation of income, there is room for mutually beneficial ad hoc restrictions on the distribution of income.

However, as discussed above, the IRS' position regarding the foreign application of *First Security Bank* was rejected in the *Procter & Gamble* case. The present regulations acquiesce to some extent in the principles of the *Procter & Gamble* case while attempting to limit the risk of collusion. Under the regulations, a foreign law restriction is only taken into account if it has been applied to other uncontrolled taxpayers in comparable situations or a three-part test is satisfied: (1) the foreign restriction is a law of general applicability that prevents payments outright rather than merely limiting associated deductions, (2) the law has not been circumvented or violated by the taxpayer, and (3) the taxpayer has exhausted its remedies under foreign law in seeking a waiver of the restriction. See Reg. § 1.482-1(h)(2).

81. As discussed below, an exception, which allows for an analysis consistent with that employed in the cases described above, involves the use of treaties in cross-border tax arbitrage. See *infra* Part III.B.

82. See Statement of U.S. Council for International Business on International Application of Check-the-Box Entity Classification Proposal of Revenue Notice 95-14, reprinted in 95 TNT 147-7 (July 28, 1995) (LEXIS, FEDTAX library, TNT file).

the facts or a legal characterization that is inconsistent with that in the other jurisdiction. As long as the United States is satisfied that its laws are being observed, what goes on outside its borders should be of no importance.

This position is correct only if (1) the consequences in one jurisdiction do not depend to any extent on the consequences in the other jurisdiction and (2) the United States has no legitimate objection when taxpayers take inconsistent positions in two jurisdictions. Conversely, the position is incorrect if either the consequences in one jurisdiction depend on the consequences in the other jurisdiction or the United States can articulate a legitimate tax policy objection to cross-border tax arbitrage.

One objection might be that, even if a U.S. tax rule does not by its terms apply differently depending on the results under foreign law, the rule might implicitly be premised on a particular treatment under foreign law. Under this view, the U.S. tax results properly may be altered if the foreign tax results are not as implicitly contemplated.⁸³

Ultimately, cross-border tax arbitrage might be the price of the absence of international consensus on tax matters.⁸⁴ In the context of international trade regulation, the laws of many nations have been harmonized, and complex multilateral treaties have been concluded.⁸⁵ In the tax area, only halting steps have been taken towards multijurisdictional harmonization.⁸⁶ Arguably, absent a global tax law, the United States can have no

83. See Daniel I. Halperin, *Are Anti-Abuse Rules Appropriate?* 48 *Tax Law.* 807, 810 (1995). This objection might be stronger or weaker depending on whether the differing tax consequences in the two jurisdictions result from inconsistent laws or inconsistently applications of consistent laws. That is, we might distinguish a case in which the laws of the two jurisdictions prescribe inconsistent results under the same view of the facts, from a case in which the taxpayer urges inconsistent views of the facts in the two jurisdictions. Arguably, in the latter case, the United States has a more legitimate objection.

84. For a forceful argument in favor of international consensus in the transfer pricing context, see Reuven S. Avi-Yonah, *The Rise and Fall of Arms Length: A Study in the Evolution of U.S. International Taxation*, 15 *Va. Tax Rev.* 89 (1995).

85. See, e.g., *General Agreement on Tariffs and Trade (GATT)*, Oct. 30, 1967, 61 *Stat.* (5)-(6), 55 *U.N.T.S.* 194; *General Agreement on Trade in Services (GATS)*, negotiated as part of the Uruguay Round of GATT negotiations (adopted in Pub. L. No 103-465, 108 *Stat.* 4809 (1994)).

86. The Organisation for Economic Co-operation and Development (OECD) is probably the best hope for those who endorse multijurisdictional tax harmonization. The OECD has developed a model bilateral tax treaty and a set of transfer pricing guidelines, portions of which have been accepted by substantially all industrialized countries. See OECD Committee on Fiscal Affairs, *Model Tax Convention on Income and Capital* (1992) [hereinafter *OECD Model Treaty*]; Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995) [hereinafter *OECD Transfer Pricing Guidelines*].

Ironically, the most logical end-game of multilateral agreement on transfer pricing matters, worldwide formulary apportionment of multinational profits (see Avi-Yonah, *supra*

legitimate objection to cross-border tax arbitrage, at least where the tax consequences in one jurisdiction do not depend on the tax consequences in any other jurisdiction.

The following questions are thus relevant to an analysis of cross-border arbitrage transactions: (1) Are the results in one jurisdiction dependent to any extent on the results in the other jurisdiction? (2) Is the U.S. tax rule that is being applied explicitly or implicitly premised on a particular tax treatment in the foreign jurisdiction? If the answers to both questions are negative, a strong argument exists that the cross-border tax arbitrage transaction is unobjectionable from a tax policy perspective.⁸⁷ If, however,

note 84), has been soundly rejected by the OECD members, including the United States. See OECD Transfer Pricing Guidelines, *supra*, ch. III.C; Regs. § 1.482-1(b). The United States even balked when faced with the prospect that its accession to a multilateral trade agreement might affect tax matters, potentially moving the United States away from its policy of entering into only bilateral tax treaties. See, e.g., John Turro, U.S. Tax Concerns Threaten GATT Talks, 7 Tax Notes Int'l 1467 (1993).

Illustrative of the difficulty of multinational tax harmonization is the experience of the European Union. The EC (and later the EU) has made sporadic attempts in the direction of harmonizing direct taxes. These efforts began as early as 1963 with the Neumark Committee Report, which recommended a uniform split rate system of corporate taxation for the EC. Only seven years later, the Van den Tempel Committee Report recommended a uniform classical system of corporate taxation. A 1975 Draft Directive proposing a partial integration system was never finalized and was withdrawn in 1990. See Proposal for a Council Directive Concerning the Harmonization of Systems of Company Taxation and of Withholding Taxes on Dividends, 1975 O.J. (C253) 2 (withdrawn Apr. 18, 1990). The only area of real progress before 1990 was in facilitating the exchange of information between taxing authorities of the member states. See, e.g., Council Directive 77/799, 1977 O.J. (L36) 15.

A package of three Directives, issued in 1990, generated some momentum in the direction of harmonization: (1) The Parent-Subsidiary Tax Directive, which is generally intended to eliminate multiple levels of corporate and withholding tax on intercorporate dividends (Council Directive 90/435, 1990 O.J. (L225) 6); (2) the Mergers (Tax) Directive, which is generally intended to facilitate tax-free business reorganizations (see Council Directive 90/434, 1990 O.J. (L225) 1); and (3) the Arbitration Convention, which prescribes procedures for member states to resolve transfer pricing issues (see Council Convention 90/436, 1990 O.J. (L225) 11). However, the implementation of these Directives has been less than complete. Several countries sought and obtained exemptions from the Parent-Subsidiary Directive, while the Mergers (Tax) Directive was modified, at the insistence of Germany, to allow a member state to deny the benefits of the Directive to a merger that contravenes labor legislation. Subsequently, a proposed directive on interest and royalty withholding taxes ran into significant political opposition from Germany and Belgium and was withdrawn. Thus, while some progress has been made, the movement towards harmonization has been fraught with difficulty and is very far from being completed. See generally Howard M. Liebman & Isret M. Sinn, *Business Operations in The European Union*, 999 Tax Mgmt. (BNA) A-95 to A-104.

87. As discussed above, it may also be relevant whether, for the inconsistent treatment to prevail, the taxpayer would be required to argue inconsistent facts, including ultimate facts, or whether a consistent view of the facts can lead to different results under the laws of both jurisdictions.

the U.S. tax rule being applied is explicitly premised on a particular foreign tax treatment, and that premise is not met, a strong argument can be made that the tax consequences under foreign law are properly taken into account in evaluating a cross-border tax arbitrage and that it is proper for the IRS or a court to deny the contemplated U.S. tax benefits. Similarly, if the tax rule is implicitly premised on a particular foreign tax treatment, and that premise is not met, the transaction is objectionable if it is legitimate to look to such an implicit premise in the absence of a formal explicit global tax law. As discussed further below, it is legitimate to do so in the treaty context. It is submitted, however, that, in general, looking to such an implicit premise in the absence of a global tax law is tantamount to an impermissible interpretive use of foreign law. Therefore, an arbitrage transaction outside the treaty context in which such premise is not met is, at least arguably, unobjectionable from a U.S. tax policy perspective.⁸⁸

With this analytical framework in mind, we now turn to an evaluation of particular cross-border tax arbitrage transactions.

A. *Entity Classification*

The Code taxes corporations, including “associations,” but does not tax partnerships, whose income is instead taxed directly to the partners.⁸⁹ Whether a given entity is an association taxable as a corporation or a partnership depends on classification rules set forth in the regulations.⁹⁰ Although all entities organized under the corporation laws of any of the 50 states or the District of Columbia are classified as corporations, the classification of foreign entities is determined under a six-part test set forth in the regulations, regardless of how similar the laws under which such entities are organized may be to domestic incorporation statutes.⁹¹

The consequences of entity classification in the foreign context differ from the consequences in the domestic context. Entity classification in the foreign context involves both U.S. entities owned by foreign persons, and foreign entities that either are owned by U.S. persons, are engaged in a U.S. trade or business, or own U.S. assets. The most important consequence in the domestic context, whether the entity is subject to U.S. tax, is not of concern with respect to a foreign entity whose owners are foreign persons and whose businesses and investments are located outside the United States. Whether such an entity is classified as a corporation or as a partnership, its business

88. In Part II above, doubt was cast on the legitimacy of interpretive uses of foreign law. In this Part, doubt is cast on the legitimacy of taking into account inconsistent results under foreign law if foreign law is used interpretatively.

89. IRC §§ 11, 701, 7701(a)(3).

90. Regs. §§ 301.7701-1 to -4.

91. Rev. Rul. 88-8, 1988-1 C.B. 403. But see *infra* note 95 and accompanying text.

profits are not taxable by the United States unless it carries on a trade or business in the United States and, if the taxpayers reside in a country having an income tax treaty with the United States, has a permanent establishment in this country.⁹² Nonbusiness income of such an entity is subject to U.S. tax only to the extent it is from U.S. sources.⁹³ Nevertheless, U.S. tax consequences can vary significantly depending on whether a foreign or a foreign-owned entity is classified as a partnership or an association taxable as a corporation.⁹⁴

92. See IRC §§ 872(a), 882(b). Under most tax treaties entered into by the United States, business income of a resident of one contracting state cannot be taxed by the other contracting state unless the person has a permanent establishment in the latter state and the income is attributable to the permanent establishment. See, e.g., Convention Between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 8, 1971, art. 8, para.1, 23 U.S.T. 967 [hereinafter U.S.-Japan Treaty]. While the definition of "permanent establishment" varies from treaty to treaty, it is intended to describe a more extensive level of business activity than the minimum level that might justify taxation by the source country. A permanent establishment may take the form of a factory or office, a construction site in existence for a specified period of time, or a relationship with a dependent agent who exercises the requisite degree of discretionary authority on behalf of the foreign entity. See, e.g., U.S.-Japan Treaty, *supra*, art. 9, paras. 1, 2.

93. IRC §§ 871(a), 881(a).

94. If a foreign entity is engaged in a U.S. business (and, in a treaty situation, has a U.S. permanent establishment), the amount of tax can vary depending on whether it is a corporation or a partnership. If the entity is owned by individuals (or trusts or estates), the tax is at the individual rates if it is classified as a partnership or at the corporate rates if it is classified as a corporation. Moreover, repatriated profits are subject to the branch profits tax of § 884 if the entity is a corporation, but not if it is a partnership and its owners are not corporations. Other consequences can also vary. For example:

- ◆ Foreign income and loss flow through to the U.S. owners of a partnership, whereas U.S. taxation of earnings of a foreign corporation may be deferred until the earnings are distributed as dividends to U.S. shareholders.
- ◆ Section 902 allows an indirect credit for foreign taxes on the income of a foreign corporation that is distributed as dividends to a domestic corporation owning at least 10 percent of the foreign corporation's stock. No other shareholders of the foreign corporation may claim credit for taxes imposed on the corporation. Credits for foreign income taxes on partnership profits are available to all U.S. partners under § 901 without regard to the owner's corporate status or ownership percentage.
- ◆ Although the indirect credit is allowed for foreign taxes on earnings of lower-tier subsidiaries distributed up the chain of ownership, it does not extend deeper than three tiers of foreign corporations. This limitation does not apply to tiered partnerships.
- ◆ Taxes paid and deemed paid with respect to dividends received by a domestic corporation eligible for the indirect credit are subject to the separate foreign tax credit limitation of § 904(d)(1)(E) if the distributing foreign corporation is not a controlled foreign corporation. Partnership income is not subject to any such limitation.

Because of the ease with which taxpayers can, under current law, achieve different classifications for entities that are virtually indistinguishable for nontax purposes, the Treasury has proposed regulations allowing taxpayers to choose the classification of their entities by simply checking a box on a form filed with the IRS.⁹⁵ In considering whether to extend this proposal to foreign entities, the Treasury initially expressed concern that it could exacerbate cross-border tax arbitrage through the use of "hybrid" entities, that is, entities that are classified as corporations in one jurisdiction and partnerships in another.⁹⁶ Although the Treasury subsequently proposed to extend the check-the-box system to foreign as well as domestic entities, it

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- ◆ Active income that flows through a partnership is not foreign personal holding company income (FPHCI) to a controlled foreign corporation (CFC). With certain exceptions, dividends from a foreign corporation to a CFC are FPHCI.
 - ◆ A foreign corporation's holding of less than 25% of the stock of another foreign corporation is a passive asset for purposes of the passive foreign investment company (PFIC) asset test. With a similar investment in a foreign partnership, the foreign corporate partner apparently may look through to the partnership's assets and characterize its investment as active or passive with reference to the character of those assets.
 - ◆ The interest allocation rules that help determine the limitation on a U.S. person's foreign tax credits may operate more favorably if a foreign investment takes the form of a partnership interest, rather than stock of a foreign corporation.
 - ◆ Foreign owners of a partnership engaged in a U.S. trade or business are themselves engaged in a U.S. trade or business and are therefore subject to U.S. tax on their distributive shares of income effectively connected with the trade or business.
 - ◆ Transfers of more than 50% of the interests in a foreign partnership within 12 months result in a termination of the partnership and a recontribution to the partnership of the partnership's assets. Any built-in gain in the assets recontributed by a U.S. person may be subject to a 35% excise tax.
 - ◆ Unlike foreign partnerships, foreign corporations can engage in tax-deferred reorganizations under subchapter C.
 - ◆ All interest payments by a foreign partnership engaged in a U.S. trade or business are treated as U.S. source and potentially subject to withholding, whereas interest payments of a foreign corporation engaged in a U.S. trade or business may be only partially U.S. source.

For a discussion of these differences in the context of elective entity classification, see New York St. Bar Ass'n, Tax Section, Report on the "Check the Box" Entity Classification System Proposed in Notice 95-14, 95 TNT 173-64 (Sept. 5, 1995) (LEXIS, FEDTAX library, TNT file) [hereinafter NYSBA Report on Notice 95-14]. For a discussion of international tax issues that arise once partnership classification is determined, see Robert J. Staffaroni, Partnerships: Aggregate vs. Entity and U.S. International Taxation, 49 Tax Law. 55 (1995).

95. PS-43-95, 61 Fed. Reg. 21,989 (1996) [hereinafter Proposed Check-the-Box Regulations]. The proposed regulations were preceded by an IRS request for comments on the check-the-box idea. I.R.S. Notice 95-14, 1995-1 C.B. 297.

96. Notice 95-14, *supra* note 95.

may still have these concerns.⁹⁷

The extent to which hybrid entities create a U.S. tax policy issue is explored below in two contexts: the foreign tax credit context and the treaty context.⁹⁸

1. *Foreign Tax Credit*.—In *Abbott Laboratories*,⁹⁹ the U.S. owner of Argentinean and Columbian entities included the earnings of those entities in its gross income and claimed direct credits for foreign taxes on those earnings.¹⁰⁰ Although the entities were classified as corporations for U.S. tax purposes, they were treated as partnerships for foreign tax purposes, and primary liability for the taxes under foreign law was thus imposed on the U.S. owner.¹⁰¹

Because the U.S. owner was primarily liable for the taxes, the owner should seemingly have been entitled to the credit under *Biddle*, which holds that whether taxes have been “paid” in the U.S. sense depends on what is required under the law of the foreign jurisdiction. The *Abbott Laboratories* court denied the credit, however, stating that whether the taxes were paid by the subsidiaries or paid by the parent does not turn solely on the legal incidence of the taxes under foreign law.¹⁰² The court appears to have been heavily influenced by the fact that, had the entities distributed their earnings, the U.S. owner would have been able to claim indirect credits for the foreign

97. See Proposed Check-the-Box Regulations Preamble (“the Treasury Department and the IRS will continue to monitor carefully the use of partnerships in the international context and will issue appropriate substantive guidance when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties”).

98. Examination of the extent to which elective entity classification would exacerbate any tax abuse associated with the use of hybrids is beyond the scope of this paper. For a fuller discussion of the issue, see American Bar Ass’n, Tax Section, Comments on Notice 95-14, Proposed Revisions to the Entity Classification Rules, 95 TNT 145-25 (July 26, 1995) (LEXIS, FEDTAX library, TNT file); NYSBA Report on Notice 95-14, *supra* note 94; Tax Executives Inst., Comments on Notice 95-14 Relating to Entity Classification, 95 TNT 147-41 (July 28, 1995) (LEXIS, FEDTAX library, TNT file).

99. *Abbott Lab. Int’l Co. v. United States*, 160 F. Supp. 321 (N.D. Ill. 1958), *aff’d per curiam*, 267 F.2d 940 (7th Cir. 1959).

100. As discussed above, direct credits are credits allowed under § 901 for taxes paid by the taxpayer claiming the credit, while indirect credits are credits allowed under § 902 for taxes paid by a foreign corporation in which the taxpayer owns at least a 10% voting interest. Indirect credits are only available when the earnings on which the foreign taxes have been imposed are distributed or taxed to its U.S. owners without distribution (e.g., under subpart F). See IRC §§ 902, 960.

101. However, the entities actually paid the taxes.

102. The court did state, however, that it was significant that the entities were secondarily liable for the tax. *Abbott Lab.*, 160 F. Supp. at 328-29.

taxes under the predecessor to section 902.¹⁰³ The court did not, however, state that it would have ruled differently had the U.S. owner been ineligible for a section 902 credit.¹⁰⁴

The court recognized that the Code provides a choice to taxpayers: (1) Do business through a foreign partnership, with the consequence that the taxpayer will immediately take the entity's foreign earnings into income and claim a credit for the foreign taxes on those earnings,¹⁰⁵ or (2) do business through a foreign corporate subsidiary, with the consequence that the taxpayer will defer both the income and the credits until the subsidiary's earnings are repatriated. Obviously, it is abusive if taxpayers defer the income and claim the credits. However, as noted above, the taxpayer in *Abbott Laboratories* did not defer the income. It agreed to take the foreign entities' earnings into income if it could credit the foreign taxes on those earnings. That is, although the taxpayer sought the advantages of partnership classification, it was also willing to live with the disadvantages of partnership classification.

The taxpayer in *Abbott Laboratories* was not so much seeking to exploit an inconsistency between U.S. and foreign law as to change the U.S. tax classification to conform to the foreign tax classification. Thus, although the taxpayer was not engaging in that which is the arguably offensive aspect of cross-border tax arbitrage, it was attempting to use foreign law in an interpretive, as opposed to a factual manner. Had the taxpayer's position prevailed in *Abbott Laboratories*, foreign law regarding entity classification would have been used as a prescriptive rule of decision to determine U.S. tax results. The United States has a legitimate tax policy objection to the result sought by the taxpayer—not an objection based on the illegitimacy of cross-border tax arbitrage, but an objection based purely on the illegitimacy of interpretive uses of foreign law.

103. *Id.* at 329 (“It is no ‘equalization’ of tax treatment to provide that a select group of taxpayers shall have it within their power to postpone the time for the realization of foreign income indefinitely [by failing to distribute it] while at the same time using foreign taxes paid on such income, to lessen their tax burden in this country”). For further discussion of the role of § 902 in the decision, see Elisabeth A. Owens, *The Foreign Tax Credit 377-80* (1961).

104. The closest the court came to such a holding was the following: It may be that a stockholder who cannot qualify for treatment under [the predecessor to § 902] and who has no control over the distribution of the profits of a foreign corporation, should be given credit under [the predecessor to § 901] where it appears that the tax paid by the corporation has been levied against him, and where he stands to lose the credit if he were to wait for the distribution.

Abbott Lab., 160 F. Supp. at 330 (citation omitted).

105. Partners are entitled to credit for their “proportionate share[s]” of the partnership's foreign income taxes. See IRC § 901(b)(5).

2. *Entity Classification and Treaties.*¹⁰⁶—Whether U.S. treaty benefits are available with respect to U.S. source income received by an entity depends in part on how that entity is classified for tax purposes.¹⁰⁷ Therefore, when U.S. and foreign law classify an entity differently, a central issue is whether U.S. or foreign law should determine the classification for treaty purposes.¹⁰⁸

To decide this issue, it may be appropriate to modify the analysis heretofore employed in this article. In the treaty context, one state grants tax benefits based on certain assumptions about the treaty partner's tax system and on the concessions granted by that other state. Therefore, a stronger basis arguably exists for using foreign law in an interpretive way where treaty issues are implicated.¹⁰⁹

The importance of this issue can be illustrated by the following example: Assume that Canadian persons own a Cayman Islands entity that

106. For a discussion of some issues that arise in connection with the treatment of partnerships under treaties, see Richard O. Loengard, *Tax Treaties, Partnerships and Partners: Exploration of a Relationship*, 29 *Tax Law* 31 (1975). See also *Comm. on Tax'n of Int'l Transactions*, Ass'n of Bar of City of New York, *United States Tax Treatment of Partnerships and Partners Under Income Tax Treaties*, 7 *Rec.* 773 (1995).

107. Generally, only treaty country "residents" are entitled to treaty benefits. Under most of our treaties, a "company" is a resident of a treaty country only if it is liable to tax in that country. Under some of our treaties, however, a partnership is also a resident to the extent that its income is subject to residence country tax in the hands of its partners. See, e.g., *Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital*, Aug. 31, 1994 [hereinafter *French Treaty*], art. 4, para. 2(b)(iv). Therefore, classification of an entity may be an implicit first step to application of the residence article of a treaty. Similarly, certain treaty benefits are available only when a resident of the treaty country is the beneficial owner of the income for which benefits are claimed. See, e.g., *Convention Between the United States of America and Canada With Respect to Taxes on Income and Capital*, Aug. 16, 1984 [hereinafter *Canadian Treaty*], art. X, para. 2. If income is received by an entity that one state views as a partnership but the other state views as a corporation, there may be disagreement on the identity of the beneficial owner.

108. Proposed regulations under § 1441 articulate the government's position that, in certain cases involving foreign entities, foreign classification rules should govern. Prop. Regs. §§ 1.1441-1(c)(6)(ii)(B), -6(b)(4).

109. Indeed, a provision found in many U.S. treaties provides express authority for interpretive uses of foreign law. See, e.g., *Canadian Treaty*, supra note 107, art. III, para. 2 ("As regards the application of the Convention by a Contracting State any term not defined therein shall, *unless the context otherwise requires* . . . , have the meaning which it has under the law of that State concerning the taxes to which the Convention applies") (emphasis added). Some treaties are even more specific in deferring to foreign law. For example, the Mexican treaty provides that, for U.S. foreign tax credit purposes, capital gains of a U.S. resident that are taxed by Mexico shall be treated as foreign source income, despite the contrary general rule of § 865(a). *Mexican Treaty*, art. 24, para. 3.

invests in U.S. dividend-paying stocks; the entity is classified as a partnership for U.S. tax purposes but as a corporation under Canadian tax laws. In the absence of a treaty, the U.S. would impose a 30% withholding tax on the dividends. Under the Canadian treaty, however, that rate is reduced if the dividend's beneficial owner is a Canadian resident. If the U.S. withholding rate is determined for treaty purposes by treating the dividend recipient as a partnership and by treating the partnership as an aggregate, the dividends qualify for the reduced rate of withholding tax on dividends under the Canadian treaty because, purely from the U.S. perspective, the owners of the Cayman entity reside in Canada. However, because the Cayman entity is classified as a corporation for Canadian tax purposes, the Canadian owners will not currently pay any Canadian income tax, directly or indirectly, on the dividend unless Canada applies rules similar to our subpart F. Moreover, the Cayman Islands has no income tax.¹¹⁰

It is arguably abusive to exploit the divergent U.S. and Canadian classifications to obtain a reduced U.S. withholding tax under the U.S.-Canada treaty, even though the dividend income may ultimately be taxed in Canada. The argument is that the fundamental purpose of the treaty is to avoid double taxation of income and that the source country treaty benefit thus is at least implicitly conditioned on the income being taxed in the residence country. It is beyond doubt that the implicit premise of the reduced withholding tax rate is the imposition of a significant income tax in the country of residence.¹¹¹ Therefore, the only question is whether this premise is entitled to recognition in the absence of more explicit articulation in the treaty or otherwise under U.S. law.¹¹²

On the one hand, since the United States does not expressly condition treaty benefits on significant income taxation by the foreign treaty partner, taxpayers appear to be within their rights in objecting to a denial of these benefits.¹¹³ For example, if Canada unilaterally reduced its income tax rate to 5%, the United States could not legitimately respond by denying treaty

110. See Howard D. Rosen, *Asset Protection Planning*, 810 Tax Mgmt. (BNA) A31.

111. It is a longstanding policy of the Treasury not to negotiate treaties with tax havens. Moreover, in many treaties, a partnership is a "resident" of a country (i.e., a person entitled to treaty benefits) only if its income is taxed in that country on a residence basis, either in its hands or in the hands of its partners. See, e.g., *Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital*, Aug. 31, 1994, art. 4, para. 2(b)(iv).

112. The "beneficial ownership" concept in many U.S. treaties may constitute such an explicit articulation.

113. For a thoughtful discussion of the legitimacy of a court sustaining such a denial of treaty benefits, see Robert Smith, *Tax Treaty Interpretation by the Judiciary: The Claims of Legitimacy* (Oct. 2, 1995) (unpublished manuscript on file with the *Florida Tax Review*).

benefits to bona fide Canadian residents. However, in the latter case, the United States might exercise its rights to renegotiate or terminate the treaty on the ground that there is no significant double taxation justifying a double tax treaty between the United States and Canada, even though it could not address this issue by selectively denying treaty benefits.¹¹⁴

As indicated above, some have suggested that a transaction like the "Cayman sandwich" described above is not a matter of legitimate concern for the United States.¹¹⁵ Rather, they suggest, any abuse is of Canadian law, which could, after all, require that the dividends be included in the income of the Canadian owners of the Cayman entity. Although there is some force to this position, it is difficult to argue that the United States may not predicate treaty benefits on the imposition of a significant tax by its treaty partner. Once that legitimacy is established, the position that the United States has no legitimate objection to this transaction loses its force.

Objections to this transaction could be addressed by requiring the U.S. entity classification to follow the foreign entity classification solely for determining whether treaty benefits are available with respect to U.S. source income. However, several issues would have to be addressed for this approach to be applied. For example, if the law of Canada were applied to classify the entity as a corporation, no treaty benefits would be available because the income would not be considered beneficially owned by a Canadian resident. However, if the entity were organized in one treaty jurisdiction that classified it as a corporation and its owners resided in another treaty jurisdiction that classified the entity as a partnership, it would be unclear which treaty would apply. Moreover, difficult issues would arise concerning the interaction of these treaty withholding rules with the rules imposing substantive liability for U.S. tax on U.S. source fixed or determinable periodic income.¹¹⁶ Would the U.S. classification rules continue to apply for purposes of determining substantive tax liability?

If foreign law were used to classify an entity for U.S. tax purposes, it would be used as a prescriptive rule of decision. That is, the terms

114. For example, on November 16, 1995, the United States announced the termination of its treaty with Malta. See John Iekel, *U.S.-Malta Tax Treaty Terminated; U.S., Swiss Officials to Resume Treaty Talks*, 11 *Tax Notes Int'l* 1426 (Nov. 27, 1995). Also, the United States and the Netherlands recently signed a protocol phasing out the remaining applicable provisions of the Netherlands treaty as extended to the Netherlands Antilles. (The phase-out continues treaty benefits for Eurobonds issued before October 15, 1984.) See *Protocol Between the Government of the United States of America and the Government of the Kingdom of the Netherlands In Respect of the Netherlands Antilles Amending Article VIII of the 1948 Convention With Respect To Taxes On Income And Certain Other Taxes As Applicable To The Netherlands Antilles*, Oct. 10, 1995, art. 1.

115. See *supra* note 84 and accompanying text.

116. IRC §§ 871, 881.

“partnership” and “corporation” would be defined for U.S. tax purposes with reference to foreign entity classification rules. As stated above, however, a compelling case could be made that the at least implicit condition of residence country taxation for treaty benefits justifies an interpretive use of foreign law in the treaty context.

Foreign law could, moreover, be used in another way in this context. If the United States negotiated treaties that more explicitly clarified that treaty benefits are tied to the imposition of tax in the residence country, foreign law would be used as fact, rather than interpretively. This recommendation could be incorporated in U.S. tax treaty policy with the following simple rule: Foreign entities would be classified as corporations for treaty purposes only if they are subject to tax in the treaty jurisdiction. This use of foreign law recognizes the dependence of one country’s laws on another’s, the “coherence” of international taxation, yet simultaneously enhances the independence and sovereignty of all nations.¹¹⁷

B. *Other Cross-Border Tax Arbitrage Transactions*

The analysis described above also can be applied to other cross-border tax arbitrage situations. This section addresses two of them: (1) inconsistent treatment of a financial instrument as debt in the issuer’s jurisdiction and equity in the holder’s jurisdiction, and (2) inconsistent treatment of a lease as providing depreciation to the legal owner in the lessor’s jurisdiction and to the beneficial owner in the lessee’s jurisdiction.

1. *Hybrid Instruments.*—Because of the interest deduction, issuing debt is generally a more tax-efficient way to raise capital than issuing equity. Conversely, because of the dividends-received deduction, equity is generally a more tax-efficient investment for a corporation than holding debt.¹¹⁸ With similar rules in other jurisdictions, issuers and holders can maximize tax benefits by treating an instrument as debt in the issuer’s jurisdiction and equity in the holder’s jurisdiction. Such an instrument may be called a hybrid instrument.¹¹⁹

117. See Kingson, *supra* note 1.

118. For the dividends-received deduction, see IRC §§ 243-246A.

119. In the domestic context, inconsistent treatment of hybrid instruments is severely limited by § 385(c), enacted in 1992 (Pub. L. No. 102-486, § 1936(a), 106 Stat. 2776, 3032), which provides that the issuer’s characterization, at the time of issuance, of an instrument as stock or debt is binding on the issuer and on all holders except holders who disclose on their tax returns that they are treating the instrument in a manner inconsistent with the issuer’s characterization. Although § 385(c) generally mandates consistent treatment for U.S. income tax purposes, it has no effect on the treatment of an instrument under foreign law. Consequently, it does not limit the inconsistent treatment of a hybrid instrument under the laws of the United States and a foreign jurisdiction.

It is clear that under U.S. law, the interest deduction is not explicitly dependent on any particular treatment of the recipient's interest income under foreign law. Neither does the dividends-received deduction explicitly depend on foreign law. It may be, however, that the rationale for the interest deduction is that the interest is subject to tax when received.¹²⁰ More clearly, the dividends-received deduction is justified as a measure to lessen the burden of multiple levels of tax on distributed corporate earnings,¹²¹ a burden that is absent if the distributed earnings were deducted from the payor's corporate tax base. Moreover, if foreign law is examined to determine whether an interest payment is taxed on receipt or a dividend payment is being deducted as interest, foreign law is used in a factual, not an interpretive, sense. That is, foreign law is used not to provide a rule of decision but to provide facts to determine whether an implicit premise of U.S. law has been satisfied.

The question that remains is whether it is legitimate to condition U.S. tax benefits on such an implicit premise. If one is of the view that taxpayers are entitled to rely on the literal language of a statute or regulation, even if that language provides a benefit at odds with the purposes of the statute or regulation, then one would not object to inconsistent treatment of payments under hybrid instruments.¹²² If, however, one believes that the government may disallow a tax benefit provided by the literal language of a rule if that benefit is inconsistent with the purposes of the rule, then one is more likely to view the implicit premises of the interest deduction and the dividends-received deduction as adequate support for denying inconsistent treatment of

120. Such a rationale was used to support the limitation on interest deductions for so-called earnings-stripping payments. See IRC § 163(j), enacted by Pub. L. No. 101-239, § 7210(a), 103 Stat. 2106, 2339 (1989); H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 569 (1989), reprinted in 1989 U.S.C.C.A.N. 3018, 3172. See generally New York St. Bar Ass'n, Tax Section, Report on Section 163(j) of the Internal Revenue Code, 47 Tax Notes 1495 (June 18, 1990).

121. For this reason, the U.S. dividends-received deduction is usually unavailable for dividends received from a foreign corporation. IRC §§ 243(a), 245.

From 1917 to 1935, corporations were not taxed on dividends received from other corporations, in order to prevent multiple levels of corporate tax. See 44 Cong. Rec. 4696 (1909) (remarks of Rep. Payne). The law was revised in 1935, however, to exempt only 85% of the dividends received in order to discourage the use of multiple entities for tax avoidance purposes and as part of a program intended to achieve simplification of corporate structures. See Revenue Act of 1935, ch. 829, § 102(h), 49 Stat. 1014, 1016. This 85% threshold was lowered to 80% in 1986, and in 1987 was again lowered, in the case of "portfolio dividends," to 70%. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 611(a)(1), 100 Stat. 2085, 2249; Revenue Act of 1987, Pub. L. No. 100-203, § 10221(a)(1), 101 Stat. 1330, 1330-408.

122. As examples of literal applications of the language of statutes or regulations, see *Brown Group, Inc. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996); *CSI Hydrostatic Testers, Inc. v. Commissioner*, 103 T.C. 398 (1994), *aff'd*, 62 F.3d 136 (5th Cir. 1995) (*per curiam*); *Woods Investment Co. v. Commissioner*, 85 T.C. 274 (1985), *acq.* 1986-1 C.B. 1.

payments under hybrid instruments.¹²³

It is the author's view that, under a system such as ours that puts a high premium on the rule of law, a transaction complying with the literal terms of the law must be respected 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.¹²⁴ Under this standard, the interest deduction cannot be denied simply because the interest payment is not subject to tax in the hands of the recipient.¹²⁵

2. *Double Dip Leases.*—A similar analysis may be applied to double dip leases—lease transactions in which legal title to property is retained by a taxpayer in a jurisdiction that provides depreciation deductions based on legal ownership, and beneficial economic ownership is transferred to a lessee in another jurisdiction that provides depreciation based on economic ownership.¹²⁶ First, where the lessor is a foreign person and the lessee is a U.S. person, the central U.S. tax consequence of a double dip lease, the availability of depreciation deductions based on economic ownership, is in no sense dependent on foreign tax rules. Second, 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.¹²⁷ 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.

IV. CONCLUSION

Notwithstanding pronouncements to the contrary, foreign law clearly has relevance to the determination of U.S. tax consequences in several contexts. This is particularly apparent in the context of the foreign tax credit,

123. See, e.g., Halperin, *supra* note 83, at 809; G.C.M. 35984 (Sept. 12, 1974).

124. The dual consolidated loss rules of § 1503(d) and the regulations thereunder perhaps represent the high water mark in explicit congressional disfavor of a tax benefit because of the relevant item's treatment under foreign law.

125. In the unusual cases where the dividends-received deduction is available for dividends paid by a foreign corporation, the payment would have to have been deducted against U.S. taxable income for the objection described above to be lodged. It is highly unlikely, however, that a corporate shareholder would claim a dividends-received deduction for a payment deducted against U.S. taxable income.

126. See Naughton, *supra* note 17.

127. U.S. depreciation deductions are limited for property used predominantly outside the United States (IRC § 168(g)(4)), but not for property used in the United States but simultaneously depreciated by different taxpayers in different jurisdictions.

for the simple reason that the credit is conceptually tied to the incidence of foreign income taxes. As discussed above, however, the application of foreign law is also important in other contexts, including transfer pricing and entity classification.

Blanket assertions of the irrelevance of foreign law are not supported by a careful reading of the case law, which demonstrates a reluctance of courts to disregard foreign law in appropriate contexts. Drawing on these authorities, this article suggests a distinction between interpretive uses of foreign law, where foreign law supplies the rule of decision, and factual uses, where foreign legal consequences are examined as facts relevant to the application of U.S. law. U.S. courts have, with few exceptions, declined to make interpretive uses of foreign law. Indeed, the basic learning of *Biddle* may be that the interests of the United States in furthering the policies of its own tax law almost always outweigh the interests of the foreign jurisdiction. Nevertheless, U.S. courts have not been willing to disregard foreign law altogether. For example, where the policy underlying U.S. rules is based on economic income, disregard of foreign laws that have an economic impact may result in a mismeasurement of income.

The distinction between interpretive and factual uses of foreign law provides a framework for analysis of when and how foreign law should be used. This analysis is important not only for interpreting statutes and regulations, but also for determining the legitimacy of tax policy objections to transactions that may at first blush seem abusive.

Admittedly, this approach is not without its problems. The factual/interpretive distinction may break down in marginal cases, and foreign law is often difficult to ascertain. Moreover, exceptions may be appropriate in particular classes of cases, such as those involving treaties. It is the author's view, however, that these difficulties do not outweigh the benefits of the factual/interpretive analytical framework. And it is the author's hope that future cases and administrative pronouncements will build on the distinction between factual and interpretive uses of foreign law to develop a more predictable and workable standard.