

## ON AND OVER THE HORIZON: EMERGING ISSUES IN U.S. TAXATION OF INVESTMENTS

*William M. Funk\**

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\* William M. Funk is the Principal of the Law Office of William M. Funk, practicing tax law for funds, businesses, individuals, and nonprofits in New York, NY. A.B. University of Chicago, J.D. Vanderbilt University School of Law, LL.M. in Taxation, New York University School of Law. The author would like to thank his colleague Solomon Steiman for his ongoing assistance in the preparation and review of this article.

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I. INTRODUCTION

President Obama already has plenty of urgent issues on his hands as he settles into governance: dealing with a once-in-a-century economic crisis, salvaging attempts at health care insurance reform, and attempting to respond to unfolding events in Afghanistan, and Iran. Still, his promises for change will not be complete without finally turning his attention to what was a centerpiece of his general election campaign: reformation of the United States' tax system. His budget proposals have started on this path by advocating curbing perceived abuses, particularly with respect to taxation of carried interests,<sup>1</sup> Subpart F, and the foreign tax credit.<sup>2</sup>

This is a propitious time to examine our tax code, particularly with respect to the world of investing. In the world of investing, proposals must go beyond plugging holes, curbing specific abuses, and then waiting for the next set of abuses to develop. We have the opportunity to consider proposals that use a more durable approach to taxation: one that makes policy decisions about the obligations of U.S. investors and the incentives needed to attract foreign investors, one that promulgates rules aligned with the intended purpose and creates enough flexibility to avoid traps for the unwary, while being immune to undesired manipulation. With this in mind, this article focuses on three emerging issues of taxation of investments – sovereign wealth funds, corporate tax residence, and notional principal contracts – in which the technical rules have come to be viewed as misaligned with desired policies, and also previews one potential new regime.<sup>3</sup>

First, this article will consider the overall goals of tax policy as have been introduced by other commentators and set forth an additional concept of durability. Second, this article will examine sovereign wealth funds (“SWFs”) by explaining their current status in the investment world, describing the history of U.S. tax

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1. See BARACK OBAMA, BARACK OBAMA'S COMPREHENSIVE TAX PLAN, [http://www.barackobama.com/pdf/taxes/Factsheet\\_Tax\\_Plan\\_FINAL.pdf](http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_FINAL.pdf) (last visited Oct. 23, 2009).

2. See DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS (2009), <http://www.ustreas.gov/offices/tax-policy/library/grnbk09.pdf>.

3. This article will not consider the carried interest issue, which has already been discussed exhaustively.

law in this area, looking briefly at how other nations tax SWFs, and then considering policy alternatives. Third, this article will examine corporate residence and U.S. anti-avoidance rules by comparing them to the rules of other nations, and will consider potential new U.S. rules. Fourth, this article will examine notional principal contracts (also known as swaps, in the main), the size of the market, their manifold uses, current U.S. taxation, and consider alternative regimes for taxation and regulation. Finally, this article will preview an additional tax regime, a financial transactions tax (“FTT”), and its potential to help to rebalance some of the equities of the system and act as a disincentive to volatility.

## II. TAX POLICY GOALS

The American Bar Association Report of the Task Force on International Tax Reform cited three policy objectives in taxing foreign business income: fairness, efficiency, and administrability.<sup>4</sup> Fairness is understood as an “ability-to-pay” criterion.<sup>5</sup> Efficiency is ensuring economic decisions are distorted as little as possible by taxes.<sup>6</sup> Administrability is understood as the “burdens of implementing a tax for both taxpayers and the government.”<sup>7</sup>

David Miller, in discussing financial instruments, listed no fewer than seventeen policy considerations: (1) ability to pay or “tax liquidity,” (2) abuse prevention, (3) administrability and compliancy, (4) certainty of result, (5) economic taxation of income, (6) financial accounting and regulatory harmony, (7) financial instrument consistency and symmetry, (8) international harmony, (9) investment promotion, (10) neutrality (efficiency), (11) perception (and politics), (12) progressivity and other distributional effects, (13) revenue, (14) simplicity, (15) stability, (16) social policy and other tax subsidies and incentives, and (17) taxpayer equity and “fairness.”<sup>8</sup> Notably, Miller makes this observation with respect to politics, and determines which of these could apply to any policy goal, by stating “positive perception may be as important as the underlying tax policies.”<sup>9</sup>

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4. *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 677 (Spring 2006).

5. *Id.* at 678.

6. *Id.* at 680.

7. *Id.* at 689.

8. David S. Miller, *Reconciling Policies and Practice in the Taxation of Financial Instruments*, TAXES, Mar. 1999, at 236.

9. *Id.* at 247.

Reuven Avi-Yonah, in discussing policy reasons for taxing the rich (and taxing the income thereof), cited curbing “excessive accumulations of political, economic, and social power by the rich.”<sup>10</sup> He also argued that preventing excessive accumulations of power and having equality furthers democracy, which may imply some degree of redistribution.<sup>11</sup> Avi-Yonah believed this does not just restrict the accumulation of private power; it regulates it and channels it by providing incentives and disincentives.<sup>12</sup> Although some of these arguments are admittedly controversial, they are notable as examples of policy motivations.

#### A. Long Term and Short Term Goals

This article will posit the added long-term policy goal of durability, which can be defined as the ability of a rule to withstand tax planning.<sup>13</sup> Two interrelated features enhance durability: vagueness and broadness.<sup>14</sup> A rule that is deliberately vague can be likened to an anti-abuse rule, except rather than be tailored to combat a specific tax planning structure, it reserves authority to the Treasury Department to respond to innovations in tax planning. One example is the reportable transaction rules of Internal Revenue Code § 6011, under which the Treasury Department makes pronouncements about transactions that are deemed abusive.<sup>15</sup> Another example is Treas. Reg. § 1.701-2, which provides a deterrent against abusive use of the partnership tax rules through a broad grant of authority.<sup>16</sup>

Broadness is achieved by treating different ways to engineer an economic result in the same way. The rules regarding outbound fixed, determinable annual or periodic payments (“FDAP”) (discussed herein) achieve this somewhat by treating many forms of outbound payments from passive investment in the same way; i.e., dividends, rents, royalties, interest other than portfolio interest, and bank deposit interest are subject to the same withholding tax under domestic U.S. tax law.<sup>17</sup>

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10. Reuven Avi-Yonah, *The Report of the President's Advisory Panel on Federal Tax Reform: A Critical Assessment and a Proposal*, 50 SMU L. REV. 551, 555 (2006).

11. *Id.* at 556.

12. *Id.* at 558.

13. See McNollgast, *The Theory of Interpretive Canon and Legislative Behavior*, 12 INT'L REV. L. & ECON. 235, 235 (1992).

14. *Id.* at 235-36.

15. I.R.C. § 6011 (2006 & Supp. 2009).

16. Treas. Reg. § 1.701-2 (1995).

17. See I.R.C. § 871(h) (2006 & Supp. 2009).

The resulting durability has several related positive outcomes. First, it achieves some predictability in the amount of revenue that can be raised by a given tax provision.<sup>18</sup> Second, it reduces the possible distortions from attempting to engineer tax-favored results by favoring one form of investment over another where the forms of investment are similar in substance.<sup>19</sup>

This article does not posit any new short-term policy goals but would emphasize a hierarchy of short-term goals in the current economic and political climate. To protect the currency at a time of increased fiscal stimulus, tax and financial policy should encourage major pools of capital that have no obligation to invest in the United States to invest in the United States. Where capital has originated in the United States, we should attempt to increase the share of taxes paid by such capital based on the concept that those who enjoy the protections of the United States have an obligation to fund the United States without regard to the jurisdiction in which the capital may be formally stored. Where possible, the tax should land on the flows of capital rather than on direct investments in businesses conducted in the United States.

The need for capital from additional sources is particularly acute. In the past year, the U.S. economy experienced the unusual and disturbing combination of volatility in stocks and a freeze in the credit markets.<sup>20</sup> In the last quarter of 2008, 95% of U.S. banks reported increasing the cost of loans to large and medium size firms.<sup>21</sup> This started a vicious cycle that has undercut demand for credit.<sup>22</sup> This, set against the background of chronic U.S. current account deficits, points to the need to attract capital from the few remaining solvent sources of capital in the world.

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18. *See id.*

19. *See id.*

20. *See generally* Barack Obama, U.S. President, Remarks By The President On 21st Century Financial Regulatory Reform (June 17, 2009), *available at* [http://www.whitehouse.gov/the\\_press\\_office/Remarks-of-the-President-on-Regulatory-Reform/](http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform/) (identifying some of the many causes and effects of the ongoing economic recession).

21. Tim Reason, *Banks Tighten the Screws*, CFO.COM, Nov. 3, 2008, <http://www.cfo.com/article.cfm/12543388>.

22. David M. Katz, *Fed: Corporate Demand for Loans Plummet*, CFO.COM, Feb. 2, 2009, <http://www.cfo.com/article.cfm/13052573>.

### III. SOVEREIGN WEALTH FUNDS AND OTHER SOVEREIGN POOLS OF CAPITAL

Sovereign wealth funds are not the only sovereign sources of capital, but rather only the latest and the fastest growing.<sup>23</sup> The world has long become accustomed to central banks and general treasuries. But sovereign wealth funds are relatively new and, prior to the current financial crisis, have been growing at an accelerated rate and so deserve special attention.<sup>24</sup>

Generally, sovereign wealth funds are “government investment vehicles that are funded with foreign exchange assets that are managed separately from official reserves” of the sovereign.<sup>25</sup> The International Monetary Fund has identified five categories of SWFs: (1) stabilization funds,<sup>26</sup> (2) savings funds,<sup>27</sup> (3) reserve investment corporations,<sup>28</sup> (4) development funds, and (5) contingent pension reserve funds.<sup>29</sup> Stephen Jen has identified five key traits of SWFs: “(1) sovereign government entities with (2) high foreign currency exposures, (3) no explicit liabilities . . . , (4) high-risk tolerance, and (5) long investment horizons.”<sup>30</sup>

SWFs have an increasingly important role in global finance, particularly in light of some of the failures of private institutions. Although the first SWF dates back to 1953, their assets under management have shown rapid growth in recent years.<sup>31</sup> The

23. See Richard Wilson, *An Introduction to Sovereign Wealth Funds*, INVESTOPEDIA.COM, <http://www.investopedia.com/articles/economics/08/sovereign-wealth-fund.asp> (last visited Oct. 23, 2009).

24. See *id.*

25. STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., ECONOMIC AND U.S. INCOME TAX ISSUES RAISED BY SOVEREIGN WEALTH FUND INVESTMENT IN THE UNITED STATES 21-22 (Comm. Print 2008) [hereinafter ISSUES RAISED BY SOVEREIGN WEALTH FUNDS].

26. *Id.* A stabilization fund has the purpose of “sterilizing” capital inflows, i.e., preventing large inflows of capital from causing significant local currency appreciation. This currency appreciation eventually causes economic feedback in the form of inflation when new local currency is exchanged for foreign-denominated assets, so increasing the money supply. This increased money supply is not accompanied by increased domestic assets, hence inflation. See JANG-YUNG LEE, STERILIZING CAPITAL INFLOWS 1 (1997), available at <http://www.imf.org/external/pubs/ft/issues7/issue7.pdf>.

27. ISSUES RAISED BY SOVEREIGN WEALTH FUNDS, *supra* note 25, at 22. These are funds that focus on long-term investing.

28. *Id.* These are funds that take a more aggressive investment position than stabilization funds when a government has deemed the stabilization fund to have accomplished its purpose. See *id.*

29. *Id.*

30. MARTIN A. WEISS, CRS REPORT FOR CONGRESS: SOVEREIGN WEALTH FUNDS: BACKGROUND AND POLICY ISSUES FOR CONGRESS 4-5 (2009), available at <http://fpc.state.gov/documents/organization/110750.pdf>.

31. Gerard Lyons, *State Capitalism: The Rise of Sovereign Wealth Funds*, 14 L. & BUS. REV. AM. 179, 179 (2008).

twin U.S. trade deficits in manufactured goods and commodities have increased the funds available to SWFs outside the U.S. while placing pressure on financial accounts to balance capital flows.<sup>32</sup> Gerard Lyons estimated in 2007 that the growth of the assets under management of some funds ranged from zero to 100 percent over the last year.<sup>33</sup>

Although there are a few large “Western” SWFs, including those of Norway and Alaska, the dominant SWFs mostly are not western.<sup>34</sup> The “super seven” SWFs are Abu Dhabi, Temasek, Ltd., GIC of Singapore, Norway, Kuwait, China, and Russia.<sup>35</sup> Also of note are the “secret funds” of the United Arab Emirates, China (again), Qatar, Brunei, Venezuela, Taiwan, Oman, and Kuwait.<sup>36</sup> In 2007, the China Investment Corporation alone was formed with \$200 billion in assets.<sup>37</sup>

Varying estimates have placed the total quantity of financial assets in the world at between \$167 trillion and \$190 trillion.<sup>38</sup> Of that, SWFs have been estimated to have between \$2 trillion and \$3.7 trillion in assets.<sup>39</sup> A September 2009 report by

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32. See *id.* at 204; See also THOMAS LUM ET AL., CRS REPORT FOR CONGRESS: COMPARING GLOBAL INFLUENCE: CHINA'S AND U.S. DIPLOMACY, FOREIGN AID, TRADE, AND INVESTMENT IN THE DEVELOPING WORLD 1-2 (2008), available at <http://fpc.state.gov/documents/organization/110750.pdf>.

33. Lyons, *supra* note 31, at 187.

34. See *id.* at 202-03.

35. *Id.* at 179.

36. *Id.*

37. *Id.* at 188.

38. *Id.* at 189 (stating global financial assets of \$167 trillion); INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: FINANCIAL MARKET TURBULENCE CAUSES, CONSEQUENCES, AND POLICIES 139 (2007), available at <http://www.imf.org/external/pubs/ft/GFSR/2007/02/pdf/text.pdf>; INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: FINANCIAL STRESS AND DELEVERAGING MACROFINANCIAL IMPLICATIONS AND POLICY 185 (2008), available at <http://www.imf.org/external/pubs/ft/gfsr/2008/02/pdf/text.pdf> (stating global financial assets of \$190 trillion in 2006). McKinsey Global Institute estimated global financial assets to have declined in value by \$16 trillion in the last year to \$178 trillion. GLOBAL CAPITAL MARKETS: ENTERING A NEW ERA 7 (2009), available at [http://www.mckinsey.com/mgi/reports/pdfs/gcm\\_sixth\\_annual\\_report/gcm\\_sixth\\_annual\\_report\\_full\\_report.pdf](http://www.mckinsey.com/mgi/reports/pdfs/gcm_sixth_annual_report/gcm_sixth_annual_report_full_report.pdf).

39. DAVID G. FERNANDEZ & BERNHARD ESCHWEILER, JPMORGAN RESEARCH: SOVEREIGN WEALTH FUNDS: A BOTTOM-UP PRIMER 7 (2008), available at [http://www.econ.puc-rio.br/mgarcia/Seminario/textos\\_preliminares/SWF22May08.pdf](http://www.econ.puc-rio.br/mgarcia/Seminario/textos_preliminares/SWF22May08.pdf) (stating SWF assets of between \$3.0 trillion and \$3.7 trillion at the end of 2007); OFFICE OF INT'L AFFAIRS, U.S. DEP'T OF THE TREASURY, REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE PRACTICES, APPENDIX 2 (2008), available at <http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates/pdf/Appendix%202.pdf> (estimating \$2.0 trillion of assets under SWF management). It should be noted the accuracy of SWF estimates has been called into question. Nadim Kawach, *Most Global Estimates About Size of SWFs are Inaccurate*, EMIRATES BUSINESS 24/7, September 28, 2009,

International Financial Services London estimated the assets under management of SWFs to be \$3.9 trillion, increasing 18% on its prior year's figure.<sup>40</sup> One estimate had SWFs owning 15% of the value of all publicly-traded stocks and bonds.<sup>41</sup> They have been projected to grow to as much as \$6 to \$10 trillion by 2013<sup>42</sup> and to \$12 trillion by 2015.<sup>43</sup> Current foreign investment in the U.S. is estimated at \$414 billion and SWFs hold between \$21.5 and \$37.9 billion.<sup>44</sup>

SWFs have also increased in public profile, if unwittingly. In the U.S., SWFs burst onto the scene with the controversy over Dubai Ports World in 2006.<sup>45</sup> Well publicized were the investments of Abu Dhabi Investment Authority into Citigroup, China Investment Company ("CIC") into Morgan Stanley, and Singapore Temasek Holdings into Merrill Lynch.<sup>46</sup> One may wonder where two of the above three U.S. institutions would have been without their infusions of SWF capital.

Such investments should not be considered relics of the pre-crisis era. In September 2009 it was reported that CIC has committed to invest approximately \$1 billion in Oaktree Capital Management, which will, in turn, invest those funds in distressed debt and other fixed income assets.<sup>47</sup> Given Oaktree's role as a fund manager in the Public-Private Investment Partnership, this is an important bellwether for future investments.<sup>48</sup>

With the benefits of infusions of large quantities of capital from SWFs come risks. Commentators have observed several risks regarding SWF investments: (1) government mismanagement of funds, (2) political manipulation, (3)

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[http://www.business24-7.ae/Articles/2009/9/Pages/27092009/09282009\\_e4325938645e452fa3828a351f333818.aspx](http://www.business24-7.ae/Articles/2009/9/Pages/27092009/09282009_e4325938645e452fa3828a351f333818.aspx).

40. IFSL RESEARCH, FUND MANAGEMENT 2009 (2009), available at [http://www.ifsl.org.uk/upload/Fund\\_Management\\_2009.pdf](http://www.ifsl.org.uk/upload/Fund_Management_2009.pdf).

41. *Sovereign-Wealth Funds: From Torrent to Trickle*, ECONOMIST, Jan. 24, 2009, at 78.

42. LEE, *supra* note 26, at 6.

43. Stephen Jen, *How Big Could Sovereign Wealth Funds Be By 2015?*, MORGANSTANLEY.COM, May 4, 2007, <http://www.morganstanley.com/views/gef/archive/2007/20070504-Fri.html#anchored3a90be-419e-11de-a1b3-c771ef8db296>.

44. Peter S. Goodman & Louise Story, *Overseas Investors Buying U.S. Holdings at Record Pace?*, N.Y. TIMES, Jan. 20, 2008, at A1.

45. Dilip Hiro, *Gulf to the US: Thanks, But No Thanks*, YALE GLOBAL ONLINE, Oct. 22, 2008, <http://yaleglobal.yale.edu/content/gulf-us-thanks-no-thanks>.

46. ISSUES RAISED BY SOVEREIGN WEALTH FUNDS, *supra* note 25, at 27.

47. Jenny Strasburg & Rick Carew, *Oaktree to Receive \$1 Billion from CIC*, WALL ST. J., Sept. 26, 2009, at B1.

48. *Id.*



protectionism, (4) market uncertainty, and (5) conflicts of interest.<sup>49</sup>

The U.S. Treasury Department has taken notice of these developments and to mitigate the risks has entered into agreements on principles with the SWFs of Singapore and Abu Dhabi.<sup>50</sup> These agreements set forth principles based upon IMF and OECD initiatives for proper conduct on both sides.<sup>51</sup> The SWF principles are: SWF investment decisions will be solely based on commercial considerations, improved disclosure, strong governance structures, fair competition, and compliance with host-nation laws.<sup>52</sup> The U.S., in turn, agreed to have no protectionist barriers to investment, a predictable framework for regulation, no discrimination among investors, no intrusion into investor decisions, and only limited restrictions based upon national security concerns.<sup>53</sup>

In the current financial crisis, the role of SWFs has become more complex. With the collapse of the commodities market in oil, Brad Setser and Rachel Ziemba have estimated that the rate of acquisition of foreign assets by SWFs has fallen considerably.<sup>54</sup> According to their estimates, the value of the assets of Gulf Cooperation Council banks and SWFs have fallen from \$1.3 trillion to \$1.2 trillion in 2008.<sup>55</sup> Moreover, the size of the Abu Dhabi Investment Authority may have been overestimated, “sometimes by as much as 100 percent.”<sup>56</sup> The *Middle East Economic Digest* reported that countries with SWFs, such as Qatar, have been purchasing domestic assets as a result of the downturn in the economy.<sup>57</sup> However, even with such reversals,

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49. *Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications: Testimony before the Sen. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 4 (2007) (statement of Edwin M. Truman, Sr. Fellow, Peterson Institute for International Economics), available at <http://www.iie.com/publications/papers/tran1107.pdf>.

50. Press Release, U.S. Dep’t of Treasury, Treasury Reached Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi (Mar. 20, 2008), available at <http://www.treas.gov/press/releases/hp881.htm>.

51. *Id.*

52. *Id.*

53. *Id.*

54. Brad Setser & Rachel Ziemba, GCC Sovereign Funds: Reversal of Fortune 1-2 (Jan. 2009) (unpublished working paper, available on the Council on Foreign Relations, Ctr. for Geoeconomic Studies website), [http://www.cfr.org/content/publications/attachments/CGS\\_Working%20Paper\\_5.pdf](http://www.cfr.org/content/publications/attachments/CGS_Working%20Paper_5.pdf).

55. *Id.* at 2.

56. *Id.* at 1.

57. Sophie Evans, *Sovereign Funds Narrow Their Focus: State Investment Vehicles Are Concentrating on Their Domestic Markets as the Value of Their Assets Falls*, MIDDLE E. ECON. DIG., May 1, 2009, available at 2009 WLNR 12596831.

SWFs remain considerable sources of capital, and increases in oil prices could create a resurgence of trends that have recently been interrupted.<sup>58</sup>

#### A. U.S. Taxation – Background

The history of U.S. taxation of foreign governments dates back to the era of World War I, when the U.S. provided sovereign immunity from U.S. taxation for income from certain investments.<sup>59</sup> Much like today's provisions, this covered income from stocks, bonds, other domestic securities, and interest from bank deposits.<sup>60</sup> The following year, this exemption was expanded to cover income "from any other source within the United States."<sup>61</sup> This exception was ruled to extend beyond income from passive investments to cover, for instance, income from sales of raw materials for flour manufacturing.<sup>62</sup> The same language appeared in the Internal Revenue Codes of 1939 and 1954.<sup>63</sup> Likewise, it was interpreted in subsequent legislative history to have provided that "these governments or organizations are completely exempt from tax in the case of income earned from sources within the United States."<sup>64</sup> It was only in 1986 that the tax exemption for governments was finally limited to investment income.<sup>65</sup>

There was some confusion about whether corporations controlled by governments were eligible for sovereign immunity. An early administrative ruling provided in 1920 that a bank established by the government of Australia was a governmental agency exempt from U.S. taxation.<sup>66</sup> This was revoked in 1946 by I.T. 3789 based on the conclusion that a corporation wholly owned by a government was separate and distinct from the government.<sup>67</sup> Further confusion was added by *Vial v. Commissioner*, which held that a Chilean government-created entity that did not take the form of a corporation under local law was part of the Chilean government because it was "created by a

58. *Id.*

59. See War Revenue Act, ch. 63, sec. 1211, § 30, 40 Stat. 300, 337 (1917).

60. *Id.*

61. Revenue Act of 1918, Pub. L. No. 65-254, § 213(b)(5), 40 Stat. 1057, 1066.

62. O.D. 182, 1 C.B. 90 (1919).

63. *Qantas Airways Ltd. v. United States*, 30 Fed. Cl. 851, 854, 859 (1994), *rev'd*, 62 F.3d 385 (Fed. Cir. 1995).

64. S. REP. NO. 87-163, at 2 (1961), *as reprinted in* 1961 U.S.C.C.A.N. 1616, 1618.

65. H.R. REP. NO. 99-841, pt. 2, at 654 (1986) (Conf. Rep.), *as reprinted in* 1986 U.S.C.C.A.N. 4075, 4743.

66. *Qantas*, 30 Fed. Cl. at 854 (citing O.D. 628, 3 C.B. 124 (1920)).

67. *Id.* (citing I.T. 3789, 1946-1 C.B. 100).

public law, as was the government, and not by a private law, as a corporation would be.”<sup>68</sup> The confusion was eventually resolved in 1975 when the Internal Revenue Service (“IRS”) issued a revenue ruling that assured that controlled entities were eligible for sovereign immunity but circumscribed the scope of that immunity.<sup>69</sup> To be eligible for sovereign immunity, the entity had to meet four requirements: (1) the entity had to be wholly owned and controlled by a foreign government; (2) the assets and income had to be derived solely from its activities and investments and from the foreign government; (3) net income had to be either credited to itself or to the government with no private inurement; and (4) its investments were solely those producing passive income such as currency deposits, stocks, notes, or securities evidencing loans.<sup>70</sup> This rule was eventually written into regulations in T.D. 7707<sup>71</sup> and was made part of the statute in 1986.<sup>72</sup>

Congress also amended the law so that sovereign immunity would not apply to dividends or interest received from U.S. controlled entities.<sup>73</sup> In 1988, Congress again amended the law to provide: (1) sovereign immunity would not apply to proceeds from dispositions of interests in controlled commercial entities; and (2) a foreign government would be deemed a corporate resident of its country for tax treaty purposes where the relevant treaty provided likewise for the U.S. government.<sup>74</sup>

#### B. *Current U.S. Taxation of Foreign Governments, Sovereign Wealth Funds et al.*

Generally, foreign investors are subject to two tax regimes that may apply simultaneously.<sup>75</sup> Foreign investors who receive passive income, such as dividends, royalties, or certain interest are subject to a withholding tax of 30% or less if provided for by

68. *Vial v. Comm’r*, 15 T.C. 403, 411 (1950).

69. *See* Rev. Rul. 75-298, 1975-2 C.B. 290.

70. *Id.*

71. *See* T.D. 7707, 45 Fed. Reg. 48,882, 48,883 (July 22, 1980).

72. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1247, § 892, 100 Stat. 2085, 2583-84 (1986) (codified as amended in scattered sections of 16 U.S.C., 19 U.S.C., 25 U.S.C., 26 U.S.C., 28 U.S.C., 29 U.S.C., 42 U.S.C., 46 U.S.C., and 49 U.S.C.).

73. *Id.* § 892, 100 Stat at 2583-84.

74. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, sec. 1012(t), § 892(a), 102 Stat. 3342, 3527-28.

75. Beckett G. Cantley, *Taxation Expatriation: Will The Fast Act Stop Wealthy Americans From Leaving The United States?*, 36 AKRON L. REV. 221, 223-24 (2003), available at <http://www.uakron.edu/law/lawreview/v36/docs/cantley36.2.pdf>.

an applicable tax treaty.<sup>76</sup> Foreign investors who are deemed to be engaged in a U.S. trade or business (whether directly or through partnership interests) and receive U.S. effectively connected income (“ECI”) are subject to taxation at regular graduated U.S. income tax rates and to tax filing requirements.<sup>77</sup>

The rules regarding foreign governments and their controlled entities provide an exception to the FDAP and ECI regimes.<sup>78</sup> Under the current version of § 892 of the Internal Revenue Code of 1986, as amended, foreign governments may receive income tax-free from: (1) their investments in stocks, bonds, and other securities; (2) interest on bank deposits; or (3) income from financial instruments held in the execution of government financial or monetary policy.<sup>79</sup> This includes income from securities lending transactions.<sup>80</sup> Financial instruments are defined as forwards, futures, options, swaps, and precious metals.<sup>81</sup>

Income from U.S. entities that are 50% or more owned by the foreign government is not exempt.<sup>82</sup> Income received by or from a controlled commercial entity or from the disposition of interests therein or from the conduct of commercial activity is not exempt from U.S. taxation.<sup>83</sup>

As indicated by the treatment of income from financial instruments, the threshold for commercial activity is an analysis separate and distinct from the quantum of activity for finding conduct of a U.S. trade or business under § 864(b).<sup>84</sup> The least amount of income from a swap or an option may be deemed to be commercial activity.<sup>85</sup> On the other hand, trading in stocks, securities, and commodities is likewise not considered commercial activity even if such activities would be considered to constitute a U.S. trade or business under § 864(b), unless such activities constituted dealer activities.<sup>86</sup> Income from net leases on real property or land not producing income is not considered commercial activity even if the disposition of such property would

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76. *Id.* This does not include portfolio interest or bank deposit interest. Bank deposit interest is often referred to as fixed, determinable annual or periodic (“FDAP”) income and is not subject to tax. *Id.*

77. *Id.*

78. *See* I.R.C. § 892 (2006).

79. I.R.C. § 892 (a)(1)(A) (2006).

80. Treas. Reg. § 1.892-3T(a)(2) (1988).

81. *Id.* § 1.892-3T(a)(4).

82. I.R.C. § 892(a)(2) (2006).

83. *Id.*

84. Treas. Reg. § 1.892-4T(b) (1988).

85. 28 U.S.C. § 1603(d) (2006).

86. Treas. Reg. § 1.892-4T(c)(1)(ii) (1988).

be subject to the Foreign Investment in Real Property Tax Act (“FIRPTA”) rules.<sup>87</sup>

A “foreign government” is defined as either its integral parts or the controlled entities thereof.<sup>88</sup> For exempt income to accrue to an integral part of government tax-free, its net earnings must accrue to its own benefit with no private inurement.<sup>89</sup> An “integral part” of a foreign sovereign is any body that constitutes a governing authority.<sup>90</sup>

A “controlled entity” of a foreign government is an entity organized under its foreign sovereign law, wholly owned and controlled by the foreign sovereign, the net earnings of which are credited to its own account or to the sovereign, and assets of which vest in the sovereign upon dissolution.<sup>91</sup> A “pension trust” may be deemed to be a controlled entity if (1) the trust is established for employees or former employees of the government; (2) is managed by the government; (3) the trust proceeds provide retirement, disability, or death benefits as consideration for prior services rendered; and (4) the trust satisfies government obligations to its employees.<sup>92</sup> Recent guidance provided an example of such a pension trust in which such trust was required to act according to a vote of a majority of the trustees, of whom a majority were either appointed by a foreign government or employees thereof.<sup>93</sup> Such pension trust was determined to be a controlled entity.<sup>94</sup>

A controlled commercial entity is any entity engaged in commercial activities if the government holds a 50% or more interest therein or a sufficient interest for effective control.<sup>95</sup> Entities that are treated as engaging in commercial activity include (1) a U.S. real property holding corporation (“USRPHC”) or a foreign corporation that would be a USRPHC if organized in the U.S.; (2) a central bank if it has commercial activity in the U.S.; or (3) controlled entities with any commercial activity anywhere, except for a pension trust with activities that would not be considered unrelated business taxable income (“UBTI”).<sup>96</sup> There is not a de minimis exception regarding commercial

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87. *Id.* § 1.892-4T(c)(1)(i).

88. Treas. Reg. § 1.892-2T(a)(1) (1988).

89. *Id.* § 1.892-2T(a)(2).

90. *Id.*

91. *Id.* § 1.892-2T(a)(3).

92. *Id.* § 1.892-2T(c)(1).

93. I.R.S. Tech. Adv. Mem. 2009-004 (May 29, 2009).

94. *Id.*

95. I.R.C. § 892(a)(2)(B) (2006).

96. Treas. Reg. § 1.892-5T(b) (2002).

activity of controlled entities, as legislative history states that the “foreign government exception” will not apply to controlled entities that engage in any commercial activities anywhere.<sup>97</sup>

### C. *Sovereign Wealth Fund Investments in Practice*

Although the provisions regarding foreign governments and SWFs have been criticized as constituting an “unwarranted tax subsidy,”<sup>98</sup> it is not clear how substantial an advantage the SWFs have. Compared to other non-U.S. investors, they can receive portfolio dividends tax-free, interest from 10% owned entities tax-free, and tax-free gains from some dispositions of USRPHC interests.<sup>99</sup> Still, the largest SWF investments into the U.S. have been through mandatory convertible securities that consist of a note and a forward contract to purchase common stock, the treatment of which was ruled upon by the IRS in Rev. Rul. 2003-97.<sup>100</sup> The holder of these securities is required to hold the securities as collateral for the forward obligation to purchase stock.<sup>101</sup> As the interest would normally be exempt portfolio interest regardless of the identity of the foreign holder, the only difference is in the treatment of dividends after settlement of the forward contract, as noted by the report to the Joint Committee on Taxation, so the SWF exception was unlikely to have made a difference in the structuring of the investment.<sup>102</sup>

### D. *Alternatives*

So what are the alternatives? Commentators have alternately called for repealing § 892, or, noting how the rules for pension trusts under § 892 already reference the UBTI regime, called for grafting the UBTI regime on to § 892.<sup>103</sup>

As noted in Part II, particularly in light of how capital has not flowed fluidly through the economy as of late thus contributing to a prolonged recession, attracting capital should be a primary goal of policy.<sup>104</sup> To balance some of the social

97. H.R. REP. NO. 99-841, pt. 2, at 654 (1986) (Conf. Rep.), reprinted in 1986 U.S.C.C.A.N. 4075, 4743.

98. Victor Fleischer, *Should We Tax Sovereign Wealth Funds?*, 118 YALE L.J. 93, 93 (2008 & Supp. 2008).

99. ISSUES RAISED BY SOVEREIGN WEALTH FUNDS, *supra* note 25, at 74.

100. *Id.* at 65-66.

101. Rev. Rul. 2003-97, 2003-2 C.B. 380.

102. ISSUES RAISED BY SOVEREIGN WEALTH FUNDS, *supra* note 25, at 2, 51, 67.

103. Peter A. Glicklich & Candace M. Turner, *Canada: Anti-Deferral and Anti-Tax Avoidance Sovereign Wealth Funds at a Disadvantage Compares to U.S. Tax-Exempts*, MONDAQ.COM, Sept. 23, 2008, <http://www.mondaq.com/article.asp?articleid=66316>.

104. See *supra* Part II.

imbalances that have been criticized over the past decade, the guiding principles should be as follows: where capital is not in the U.S. or under its direct or indirect regulation, we should encourage more of it to flow back into the U.S.; where it is under U.S. regulation, we should endeavor that those who control the largest capital flows should pay a greater share of the tax burden and we should establish rules that attempt to tax capital according to the substance and reality of relevant transactions.

As a practical matter, we should consider the source of the funds in making policy, particularly how the capital was acquired in the first place. In investigating the commonalities China, Russia, Abu Dhabi, Oman, Kuwait and Qatar, it is discovered that they all have been major destinations of capital from Western consumption. China's capital derived from purchases of manufactured goods and the other countries' capital is derived from purchases of natural resources such as oil and natural gas.<sup>105</sup> There is a positive policy goal of attracting capital, rebalancing balances of cash flows, and essentially repatriating that money. Or, as former Treasury Secretary Henry Paulson said, "I'd like nothing more than to get some of that money."<sup>106</sup>

As noted in the *Taxation of the Passive Income of Foreign Governments and Sovereign Wealth Funds in Selected Foreign Countries* report to Congress, many Western nations already provide exemptions from taxation for SWFs.<sup>107</sup> Some have done so through administrative means and, in two cases, on a country-by-country basis.<sup>108</sup> Others provide exemptions for SWFs as part of a broader exemption for foreign investors, so an expanded U.S. exemption would be within the mainstream of Western policy on SWFs.<sup>109</sup>

Japan and the nations of the British Commonwealth (United Kingdom, Canada, and Australia), like the U.S., base their foreign government exemptions on sovereign immunity.<sup>110</sup> Japan and the U.K. provide exemptions through administrative practice.<sup>111</sup> Australia and Canada allow foreign governments to

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105. WEISS, *supra* note 30, at 10 (SWFs financed by oil and gas purchases are estimated to account for two-thirds of SWFs by assets under management and Asian funds financed by current account surpluses comprise the rest).

106. Steven R. Weisman, *A Fear of Foreign Investments*, N.Y. TIMES, Aug. 21, 2007, at C1.

107. This report constitutes Appendix One of ISSUES RAISED BY SOVEREIGN WEALTH FUNDS, *see* ISSUES RAISED BY SOVEREIGN WEALTH FUNDS, *supra* note 25, at 1, 77.

108. *Id.* at 77.

109. *Id.*

110. *Id.*

111. *Id.*

seek exemptions through ruling requests.<sup>112</sup> Continental European nations are less likely to provide exemptions. Some continental European nations provide exemptions only through tax treaties on a nation-by-nation basis.<sup>113</sup> However, this more restrictive policy is often balanced by a more liberal general policy with respect to taxation of foreign investors.<sup>114</sup>

For those nations that provide exemptions, these exemptions are sometimes, but not always, extended to SWFs.<sup>115</sup> The U.K. denies the exemption to funds that are entities separate from governments.<sup>116</sup>

Then, we should consider some of the shortcomings of current tax policy. As currently constituted, the SWF rules are a palimpsest of prior tax policies that have little to do with current U.S. needs. They started with their roots in the sovereign immunity doctrine and were amended to address concerns about commercial activities and about treaty reciprocity.<sup>117</sup> The current rules require tax advisors to conduct deep inquiries into facts that should be considered of dubious relevance to the U.S. balance sheet (e.g., whether controlled entities do the least quantum of commercial activity anywhere in the world) and they effectively prohibit SWF investors from benefiting from even the most conservative use of derivative instruments – hedging or insuring against the risks of their investments.<sup>118</sup>

Fortunately, we do not need to design new rules from scratch. The UBTI rules, including the unrelated debt-financing income (“UDFI”) rules for tax-exempt organizations already provide a robust exemption from taxation for passive income while preventing potential abuses.<sup>119</sup> The UBTI rules, as evolved, have three wellsprings of policy: (1) to permit passive investment in a broad portfolio of assets, including real estate, (2) to prevent unfair competition against active businesses, and (3) to prevent taxable co-venturers from using tax-exempts as tax-

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112. *Id.*

113. ISSUES RAISED BY SOVEREIGN WEALTH FUNDS, *supra* note 25, at 77.

114. *Id.* at 77-78.

115. *Id.*

116. *Id.* at 77.

117. Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 N.Y.U. L. REV. 440, 456-61 (2009).

118. Michael S. Knoll, *Taxation and the Competitiveness of Sovereign Wealth Funds: Do Taxes Encourage Sovereign Wealth Funds to Invest in the United States?* 25 (Oct. 28, 2008) (unpublished manuscript, available on the NELLCO Legal Scholarship Repository website), [http://lsr.nellco.org/cgi/viewcontent.cgi?article=1251&context=upenn\\_wps](http://lsr.nellco.org/cgi/viewcontent.cgi?article=1251&context=upenn_wps).

119. *See* I.R.C. § 512 (2006 & Supp. 2009).



indifferent parties in avoidance schemes.<sup>120</sup> Accordingly, we should consider a modified UBTI regime for SWFs.

Currently, pension funds and tax-exempt organizations are subject to the UBTI and UDFI rules.<sup>121</sup> These rules provide for imposition of U.S. federal income tax on UBTI.<sup>122</sup> Income from passive sources such as dividends, interest, securities loans, rents from real property and most gains from disposition of property, including real property, is exempt from taxation as UBTI.<sup>123</sup> Income from debt-financed property may be subject to taxation under the UDFI rules.<sup>124</sup> Debt-financed property is any property held for the production of income for which there is acquisition indebtedness.<sup>125</sup> Acquisition indebtedness is indebtedness incurred to acquire or improve property, even if the indebtedness occurred before or after the acquisition or the improvement of such property.<sup>126</sup> There is an exception, however, for indebtedness incurred by a qualified organization (such as a pension fund or an educational institution) for acquiring or improving real property.<sup>127</sup> This exception is available provided (1) the price of the acquisition is fixed as of the date of acquisition or completion of the improvement, (2) there is no “equity kicker” to the lender from the property, (3) the property is not leased to the seller, (4) the property is not leased to certain related persons, or (5) where held through a partnership, the allocations comply with the “fractions rule” of § 514(c)(9)(B).<sup>128</sup> The fractions rule requires that the greatest share of income allocable to a qualified person can never exceed the lowest share of loss allocable to the qualified organization and that the allocations have substantial economic effect.<sup>129</sup>

If governments and SWFs were subject to a UBTI regime, acquisition of real property by a SWF for investment and disposition would no longer give rise to commercial activity, a U.S. trade or business, or U.S. effectively connected income.<sup>130</sup>

120. *Id.*

121. PATRICK FENN & DAVID GOLDSTEIN, TAX CONSIDERATIONS IN STRUCTURING US-BASED PRIVATE EQUITY FUNDS 2 (2002), <http://www.akingump.com/files/Publication/0185da1b-ff24-4dc0-8f92-9bc87bbf16cf/Presentation/PublicationAttachment/f6c8f918-a7ae-4eca-b541-9fe32902d2b2/376.pdf>.

122. I.R.C. § 511 (2006).

123. I.R.C. §§ 512(b)(1), (b)(3), (b)(5) (2006 & Supp. 2009).

124. I.R.C. § 514(a) (2006 & Supp. 2009).

125. I.R.C. § 514(b)(1) (2006 & Supp. 2009).

126. I.R.C. § 514(c)(1) (2006 & Supp. 2009).

127. I.R.C. § 514(c)(9)(B) (2006 & Supp. 2009).

128. *Id.*

129. I.R.C. § 514(c)(9)(E)(i) (2006 & Supp. 2009).

130. *See* I.R.C. § 512(a)(2)(A) (2006 & Supp. 2009).

Although the use of debt by SWFs is not an abuse that this policy would be concerned with, there is still potential for abuse in the partnership form through allocations of income to tax-indifferent parties.<sup>131</sup> Accordingly, the UDFI rules of § 514 should also be applicable with foreign governments and SWFs being deemed to be qualified organizations.

This would also entail the first major new exception to FIRPTA in recent memory. With the real-estate led recession and record drops in the real property prices, we should now be encouraging SWFs to inject capital directly into the U.S. real estate market. Adopting such an exception would respond to criticism that the U.S. tax law acts as a disincentive for SWFs to invest in U.S. real estate.<sup>132</sup>

Even one year after the demise of Lehman Brothers, a \$700 bailout and passage of a \$787 stimulus package, leading investors such as Bill Gross of PIMCO are warning of the potential for deflation.<sup>133</sup> Considering that economists such as Nouriel Roubini have been warning of the prospect of an “L-shaped recession,” a deep recession with a weak and long recovery, and HSBC’s chief executive officer is now warning of the risk of a W-shaped recovery (meaning a double-dip recession),<sup>134</sup> providing for a sunset of, for instance, five years from enactment for such exempt investments may be a significant boost to stimulus efforts currently underway and so are crucial to the goal of attracting capital.<sup>135</sup>

#### IV. CORPORATE RESIDENCE RULES

The United States provides that domestic corporations are subject to taxation on worldwide income.<sup>136</sup> The touchstone of U.S. corporate taxation has been, to an unusual degree, based on the place of incorporation of the entity.<sup>137</sup> Section 7701(a)(30)(C)

131. See I.R.C. § 512(e) (2006 & Supp. 2009).

132. Martin Hurst, *Sovereign Wealth Funds Hit by US Property Tax*, IPE REAL ESTATE, Oct. 12, 2009, [http://www.ipe.com/realestate/sovereign-wealth-funds-hit-by-us-property-tax\\_32967.php](http://www.ipe.com/realestate/sovereign-wealth-funds-hit-by-us-property-tax_32967.php).

133. Thomas R. Keene & Suzanne Walker, *PIMCO’s Gross Buys Treasuries Amid Deflation Concern*, BLOOMBERG.COM, Sept. 29, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=a5qkMIPH67tQ>.

134. Patrick Jenkins, *HSBC Chief Fears a Second Downturn*, FT.COM, Oct. 5, 2009, [http://www.ft.com/cms/s/0/41c8f48a-b10d-11de-b06b-00144feabdc0.html?nclick\\_check=1](http://www.ft.com/cms/s/0/41c8f48a-b10d-11de-b06b-00144feabdc0.html?nclick_check=1).

135. E.g., Nouriel Roubini, *HOME (Home Owner’s Mortgage Enterprise): A 10 Step Plan to Resolve the Financial Crisis*, RGE MONITOR, Sept. 28, 2008, [http://www.rgemonitor.com/roubinimonitor/253739/home\\_home\\_owners\\_mortgage\\_enterprise\\_a\\_10\\_step\\_plan\\_to\\_resolve\\_the\\_financial\\_crisis](http://www.rgemonitor.com/roubinimonitor/253739/home_home_owners_mortgage_enterprise_a_10_step_plan_to_resolve_the_financial_crisis).

136. I.R.C. § 862(a) (2006).

137. I.R.C. §§ 7701(a)(4)-(5) (2006).

defines a U.S. person to include a domestic corporation.<sup>138</sup> Section 7701(a)(4) then states that a domestic corporation is a corporation organized in the U.S.<sup>139</sup>

Prior to 2004, the primary approach for taxing income under the control of U.S. persons but held in foreign corporations was through anti-avoidance regimes such as the controlled foreign corporation (“CFC”) regime and the passive foreign investment company (“PFIC”) regime.<sup>140</sup> In 2004, Congress created a major exception to the place of incorporation rule to deem certain foreign corporations to be domestic corporations under the anti-inversion rules.<sup>141</sup>

#### A. *Controlled Foreign Corporations*

The CFC regime was the first major anti-avoidance regime the U.S. established that was specifically targeted at outbound investment.<sup>142</sup> Congress identified tax deferral, especially through “tax havens,” as an evil that tax policy should restrict.<sup>143</sup> Quoting President John F. Kennedy, the Senate Report stated:

The undesirability of continuing deferral is underscored when deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more countries organized abroad by American firms have arranged their corporate structures . . . so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities at home and abroad.<sup>144</sup>

For CFCs, the target is foreign corporations controlled by “U.S. shareholders” whether by greater than 50% ownership of value or greater than 50% control of voting, including by indirect

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138. I.R.C. § 7701(a)(30)(C) (2006).

139. I.R.C. § 7701(a)(4) (2006).

140. See I.R.C. § 951 (2000). Congress has most recently expanded on the anti-avoidance framework in the Emergency Economic Stabilization Act of 2008 with new I.R.C. § 457A, setting forth new rules regarding deferred compensation from foreign jurisdictions.

141. I.R.C. § 7874(b) (2006). There are also exceptions to the place of incorporation rule for electing contiguous country corporations and “stapled entities,” neither of which will be discussed herein. I.R.C. § 269B (2006); I.R.C. § 1504(d) (2006).

142. S. REP. NO. 87-1881, at 61-62 (1962).

143. See *id.*

144. *Id.*

control.<sup>145</sup> U.S. shareholders are U.S. persons with at least 10% of the voting stock of the corporation.<sup>146</sup>

United States shareholders of CFCs are taxed on a deemed pass-through basis with respect to “Subpart F income,” which includes “foreign base company income,” insurance income, and certain amounts related to international boycott income and illegal payments.<sup>147</sup> Foreign based company income includes passive income or “foreign personal holding company income” under § 954(c), which, in turn, includes interest, dividends, royalties, rents, and annuities capital gains from certain property transactions, commodities gains, foreign currency gains and income from notional principal contracts (but does not apply to certain related-party payments of passive income).<sup>148</sup> Foreign-based company income also includes income from related person sales of goods or services outside the foreign corporation’s country of incorporation.<sup>149</sup> In addition to these items of income, a U.S. person who owned ten percent or more of the total combined voting power of the CFC at any time in the five-year lookback period must treat any gain from disposition of CFC stock as a deemed dividend per the rules of § 1248.<sup>150</sup>

### B. *Passive Foreign Investment Companies*

The Passive Foreign Investment Companies (PFIC) regime, enacted in 1986, operates by providing a punitive regime for taxation of dividends and capital gains.<sup>151</sup> In the Bluebook, the Joint Committee on Taxation stated that, “Congress did not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make investments outside the United States rather than inside the United States.”<sup>152</sup> Congress did not want the nationality of those who control the investment vehicle to determine how the domestic shareholders should be taxed.<sup>153</sup> Congress also recognized that shareholders in foreign investment

145. I.R.C. § 957(a) (2006 & Supp. 2009).

146. I.R.C. § 951(b) (2006 & Supp. 2009).

147. I.R.C. §§ 951(a)(1), 952(a) (2006 & Supp. 2009).

148. I.R.C. §§ 954(a)(1), (c)(1)(A) (2006 & Supp. 2009).

149. I.R.C. § 954(d)-(e) (2006 & Supp. 2009). Foreign base company income also includes “foreign base company oil related income.” I.R.C. § 954(g) (2006 & Supp. 2009).

150. I.R.C. § 1248(a) (2006 & Supp. 2009).

151. I.R.C. §§ 1291, 1294, 1296-98 (2006 & Supp. 2009); I.R.C. §§ 1293, 1295 (2006).

152. STAFF OF THE JOINT COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 1023 (Comm. Print 1987).

153. *Id.*

vehicles obtained benefits both in deferral of taxation and in allowing conversion of ordinary income into capital gains.<sup>154</sup>

To combat these perceived abuses, Congress enacted special rules for shareholders of PFICs.<sup>155</sup> A PFIC is defined as a foreign corporation that either has 75% or more total gross income from passive income as per § 954(c) or 50% or more of the average value of its assets which generate passive income.<sup>156</sup> The PFIC regime also provides that for a foreign corporation that owns more than 25% of the value of another corporation, the PFIC asset and income tests will be applied on a pass-through basis, examining the assets and income of such corporation as if held directly by the tested foreign corporation.<sup>157</sup>

U.S. shareholders of PFICs are subject to taxation under one of three regimes: the excess distribution regime (which is the default regime), the qualified electing fund (“QEF”) regime, and the mark-to-market regime.<sup>158</sup> In the excess distribution regime, a PFIC shareholder is not taxed currently on PFIC earnings, but must compute tax on “excess distributions” from corporate distributions or sales of stock by first treating all such income as ordinary income, regardless of whether the PFIC has any earnings and profits.<sup>159</sup> An amount deemed as excess distribution is an amount by which a corporate distribution exceeded 125% of average distributions over the prior three years.<sup>160</sup> Amounts may be deemed to be excess distributions without regard to the PFIC shareholder’s basis in the stock or amounts of earnings and profits of the PFIC.<sup>161</sup> Then the shareholder is required to allocate amounts to prior tax years in which the shareholder was a PFIC shareholder and add an interest charge based on the “deferred tax amount.”<sup>162</sup> The deferred tax amount is the amount of tax that would have been due on amounts of excess distributions applied to prior tax years.<sup>163</sup>

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154. *Id.*

155. *Id.* at 1023-24.

156. I.R.C. § 1297(a) (2006 & Supp. 2009); *see also* I.R.C. § 954(c) (2006 & Supp. 2009).

157. I.R.C. § 1297(c) (2006 & Supp. 2009).

158. I.R.C. §§ 1291, 1296 (2006 & Supp. 2009); I.R.C. § 1295 (2006); *see also* Instructions for Form 8621, <http://www.irs.gov/instructions/i8621/ch01.html> (last visited Oct. 23, 2009).

159. *See* I.R.C. § 1291(a)-(b) (2006 & Supp. 2009).

160. I.R.C. § 1291(b)(2)(A)(ii) (2006 & Supp. 2009).

161. Prop. Treas. Reg. § 1.1291-2(c), 57 Fed. Reg. 11024-01, 11037 (Apr. 1, 1992).

162. *Id.*

163. I.R.C. § 1291(c) (2006 & Supp. 2009).

A shareholder of a PFIC may elect out of the excess distribution regime by filing an election to have the PFIC treated as a QEF.<sup>164</sup> A shareholder electing QEF treatment generally must recognize the ratable share of PFIC earnings, allocated to the categories of ordinary income and capital gains on a pass-through basis.<sup>165</sup> A PFIC shareholder also has the option of making a protective QEF election if he or she reasonably believes that the foreign corporation is not a PFIC at the time of the election, but wishes to avoid the excess distribution regime if in subsequent years it is determined that the foreign corporation is a PFIC.<sup>166</sup>

Investors in PFICs that are regularly traded on a recognized exchange also have the option to elect mark-to-market recognition of income.<sup>167</sup> In this regime, the PFIC shareholder recognizes income or deduction based on the change in the fair market value of the stock against the adjusted basis over the taxable year.<sup>168</sup> Basis is then adjusted according to the income or deduction recognized.<sup>169</sup>

### C. *Anti-Inversion Regime*

In sharp contrast in approach are the anti-inversion rules of § 7874.<sup>170</sup> After a long-simmering controversy over the perceived abuse of U.S. corporations with multi-national operations creating structures with new parent companies in low-tax jurisdictions to engineer territorial taxation, Congress enacted § 7874 as part of the American Jobs Creation Act of 2004.<sup>171</sup> In the legislative history, the House Committee Report stated,

[C]orporate inversion transactions were a symptom of larger problems with our current system for taxing U.S. based global businesses and were also indicative of the unfair advantages that our tax laws conveyed to foreign ownership. The [bill] addressed the underlying problems with the U.S. system of taxing U.S. based global businesses, and

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164. I.R.C. § 1295 (2006).

165. I.R.C. § 1293(a) (2006).

166. Treas. Reg. § 1.1295-3(b) (2000).

167. I.R.C. § 1296 (2006 & Supp. 2009).

168. I.R.C. § 1296(b) (2006 & Supp. 2009).

169. *Id.*

170. *See* I.R.C. § 7874 (2006).

171. *See* I.R.C. § 7874 (2006).

this provision removes the incentives for entering into inversion transactions.<sup>172</sup>

The approach of § 7874 is a two-pronged approach: (1) imposing a tax on the inversion gain by disallowing other offsetting tax attributes or (2) deeming certain inverted corporations to still be U.S. corporations.<sup>173</sup> Although § 7874(d)(2) refers explicitly to “inversion gain,” the term “inversion” itself is never used to describe inversion transactions.<sup>174</sup> By inference, what are generally known as inversion transactions are direct or indirect acquisitions of substantially all the properties held directly or indirectly by a domestic corporation or of the property constituting the trade or business of a domestic partnership by a foreign corporation where former shareholders or partners hold at least 60% of the stock of the foreign corporation.<sup>175</sup> In such transactions, the foreign corporation is deemed to be a “surrogate foreign corporation” and the domestic corporation or partnership an “expatriated entity.”<sup>176</sup>

Expatriated entities are required to recognize inversion gain in any year in the period from the first transfer of properties in an inversion transaction to ten years from the last date properties are acquired in such an inversion transaction.<sup>177</sup> Inversion gain includes income received or accrued in the applicable period by reason of a license of property to a “foreign related person,” a foreign person either related to or under common control with the expatriated entity under § 482.<sup>178</sup> In such transactions, credits other than from the foreign tax credit are generally disallowed and are permitted only to the extent that the tax on the expatriated entity exceeds the highest rate of tax on inversion gains.<sup>179</sup>

The anti-inversion rules also deny net operating losses in inversion transactions by incorporating the real estate mortgage investment conduit loss denial rules of § 860E.<sup>180</sup> Under § 860E(a)(3), “excess inclusions” shall not be taken into account

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172. STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., REPORT ON TAX LEGISLATION ENACTED IN THE 108TH CONG. 343 (Comm. Print 2005).

173. See generally I.R.C. § 7874 (2006).

174. See I.R.C. § 7874(d)(2) (2006).

175. See I.R.C. §§ 7874(a)(2)(A)-(B) (2006).

176. See *id.*

177. I.R.C. §§ 7874(a)(1), (d)(1) (2006).

178. I.R.C. §§ 7874(d)(2)-(d)(3) (2006); see also I.R.C. § 482 (2006).

179. I.R.C. § 7874(e)(1) (2006).

180. I.R.C. § 7874(e)(3) (2006); I.R.C. § 860E (2006).

in determining net operating loss or taxable income.<sup>181</sup> Under § 172(c), net operating loss is the excess of deductions over income.<sup>182</sup> Therefore, the effect is that inversion gain is not taxable income that can be used for computing net operating loss, effectively preventing its use.

For expatriated entities that engage in inversion transactions in which former shareholders or partners control 80% of the foreign corporation after the transactions, the toll charge regime does not apply.<sup>183</sup> Instead, the foreign corporation is deemed to be a domestic corporation.<sup>184</sup>

This hybrid approach contrasts significantly to the approach of several of the leading U.S. trading partners. Another approach, which has been praised by commentators such as Lee Sheppard, is to treat corporations that are managed in the United States as domestic corporations.<sup>185</sup> This section will now examine the approaches taken by the United Kingdom (the “U.K.”), the People’s Republic of China (“P.R.C.”), and Switzerland to have their corporate tax regimes reflect the realities of corporate management.

#### D. Alternate Approaches: United Kingdom

The U.K. provides for worldwide taxation of U.K. resident corporations, which are either corporations incorporated under U.K. law or foreign corporations with central management and control located in the U.K.<sup>186</sup> The latter test has developed from more than one and a quarter centuries of case law.<sup>187</sup>

The first cases date back to 1876 when in *Calcutta Jute Mills Co. v. Nicholson*, a company doing business in India had to have its residence determined for taxation.<sup>188</sup> Calcutta Jute Mills Company was a U.K. company that conducted all of its business in India and had no office in the U.K.<sup>189</sup> All of its books and records were kept in India.<sup>190</sup> Its directors lived in England

181. I.R.C. § 860E(a)(3) (2006).

182. I.R.C. § 172(c) (2006 & Supp. 2009).

183. I.R.C. § 7874(a)(3) (2006).

184. I.R.C. § 7874(b) (2006).

185. Lee A. Sheppard, *News Analysis: Problems Facing the President-Elect*, 121 TAX NOTES 783, 783 (2008).

186. Company Residence: Statement of Practice 1/90 para. 1, <http://www.hmrc.gov.uk/manuals/intmanual/INTM120140.htm> (last visited Oct. 23, 2009).

187. *Id.* at para. 9.

188. *The Calcutta Jute Mills Co. v. Nicholson*, [1876] 1 Exch. Div. 428, 429.

189. *Id.*

190. *Id.*



and met in England.<sup>191</sup> The court stated that a company has its residence where the “real trade and business is carried on.”<sup>192</sup> The court also noted that all the powers of the corporation were vested by its constitution in the directors.<sup>193</sup> The court then determined that a company can reside both at its place of incorporation and where “its governing body . . . exercises the powers conferred upon it.”<sup>194</sup> Based on this, the court held that under both tests, the company’s residence was in the U.K.<sup>195</sup> This left open the question of how to treat a corporation incorporated under foreign law, but with U.K. directors.<sup>196</sup>

This question was addressed in *De Beers Consolidated Mines v. Howe*.<sup>197</sup> De Beers, the diamond dealer, had its main office in Kimberley, South Africa, where it conducted a mining business.<sup>198</sup> It sold diamonds to a syndicate in South Africa.<sup>199</sup> The majority of its directors lived in England.<sup>200</sup> Although meetings of directors occurred in Kimberley and London, it was at the London meetings where real authority was exercised.<sup>201</sup>

In grappling with the issue for how to determine the residence of an entity rather than a human being, the court stated, “[a] company cannot eat or sleep, but it can keep house and do business.”<sup>202</sup> Following this insight, the court followed *Calcutta Jute Mills* and stated “a company resides for purposes of income tax where its real business is carried on . . . . I regard that as the true rule, and the real business is carried on where the central management and control actually abides.”<sup>203</sup> The court then held that because the directors of De Beers acted in the U.K. and central management and control was located in the U.K., De Beers, therefore for tax purposes, resided in the U.K.<sup>204</sup>

Thus, the test did not look to the day-to-day management but instead to the location of the highest level of control of the

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191. *Id.*

192. *Id.* at 452.

193. *Id.* at 444.

194. *The Calcutta Jute Mills Co. v. Nicholson*, [1876] 1 Exch. Div. 428, 445.

195. *Id.* at 445-46.

196. *See generally id.* at 451.

197. *De Beers Consol. Mines, Ltd. v. Howe*, [1906] A.C. 455, 455-57 (H.L.) (appeal taken from K.B.) (U.K.).

198. *Id.* at 458-59.

199. *Id.* at 459.

200. *Id.*

201. *Id.*

202. *Id.* at 458.

203. *De Beers Consol. Mines, Ltd. v. Howe*, [1906] A.C. 455, 458 (H.L.).

204. *Id.* at 459.

business, which is a question of fact.<sup>205</sup> Usually, that would be the location of meetings of the board of directors, but that is not necessarily conclusive.<sup>206</sup> By this reasoning, a formal grant of authority by the board of directors or by the corporate charter to specific officers could effectively transfer central management and control.<sup>207</sup>

United Kingdom courts may also look at whether power formally vested in a board of directors has been usurped by another party.<sup>208</sup> In *Unit Construction Co. v. Bullock*, a subsidiary of an English company made payments to sibling Kenya companies and sought to deduct the payments, which would be permitted only if the Kenya companies were deemed to be U.K. residents.<sup>209</sup> The constitutions of the Kenya companies required that they be managed in Kenya, or at least outside the U.K., and that “[d]irectors meetings may be held anywhere outside the United Kingdom.”<sup>210</sup> The Kenyan companies, however, were so mismanaged that the U.K. parent company decided that “the condition of the African subsidiaries was becoming so serious that it was unwise to allow them to be managed in Africa any longer, and that their management must be taken over by the directors of Alfred Booth & Co. Ltd. in London.”<sup>211</sup> Based on this, it was held that the place of central management and control shifted to the U.K.<sup>212</sup> *Unit Construction* restated that determination of central management and control was a question of fact and “[n]othing can be more factual . . . than the acts of management which enable a court to find as a fact that central management and control is exercised in one country or another.”<sup>213</sup>

HM Revenue and Customs interpreted *Unit Construction* as supporting the following approach when there are doubts about company residence status: (1) “ascertain whether the directors . . . exercise central management and control”; (2) if so, “determine where [they] exercise this central management and control”; and (3) if the directors “do not exercise central

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205. *Id.* at 458.

206. *See id.* at 459.

207. *See id.*

208. *Unit Constr. Co. Ltd. v. Bullock (Inspector of Taxes)* [1960] A.C. 351.

209. *Id.* at 353-54.

210. *Id.* at 353.

211. *Id.*

212. *Id.*

213. *Id.* at 362.

management and control,” determine who does exercise such authority and where.<sup>214</sup>

United Kingdom courts did draw a line between influence and usurpation in *Wood and another v. Holden*.<sup>215</sup> This case concerned capital gains on a 1996 sale of shares of stock in a family-run business by Copsewood Investments Ltd., a British Virgin Islands company (“Copsewood”), to Eulalia Holdings BV, a Netherlands corporation (“Eulalia”), subject to a kicker if Eulalia resold the stock within three years.<sup>216</sup> The Woods wished to sell their shares in the family business, but wished to minimize the tax on their potentially substantial capital gains.<sup>217</sup> Because of changes in U.K. tax law, the Woods were advised by Price Waterhouse to have Copsewood acquire Eulalia to be a wholly-owned subsidiary, transfer the shares in the business to Eulalia, and then have Eulalia sell the shares.<sup>218</sup> Eulalia did resell the stock at gains.<sup>219</sup>

The revenue authorities “did not accept that Eulalia was not a resident” of the U.K.<sup>220</sup> The revenue authorities stated that the taxpayers failed to show that central management and control was not exercised in London once Copsewood became the sole shareholder of Eulalia.<sup>221</sup> It was surmised that Eulalia had no independent basis for deciding whether to purchase and sell the shares, or the terms of the sales, and that Eulalia’s director, ABN AMRO, could not have exercised independent judgment in the time in which the transactions occurred.<sup>222</sup> Therefore, the decisions must have reflected only the wishes of the Woods and their advisers.<sup>223</sup>

When this matter was presented before the court, it held first that the revenue authorities had misstated the evidentiary burden, and then that once the taxpayers met their burden of production by providing evidence of foreign residence, the burden of proving U.K. residence passed back to the Revenue.<sup>224</sup> In

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214. Company Residence: Statement of Practice 1/90 para. 15, <http://www.hmrc.gov.uk/manuals/intmanual/INTM120140.htm> (last visited Oct. 23, 2009).

215. *Wood and another v. Holden* (Inspector of Taxes), [2006] 1 W.L.R. 1393, 1410 (C.A. (Civ. Div.)).

216. *Id.* at 1395.

217. *Id.* at 1399.

218. *Id.* at 1399-1400.

219. *Id.* at 1402.

220. *Id.* at 1396.

221. *Wood and another v. Holden* (Inspector of Taxes), [2006] 1 W.L.R. 1393, 1404-05 (C.A. (Civ. Div.)).

222. *Id.* at 1407-08.

223. *Id.*

224. *Id.* at 1413.

determining the residence tests, the court also distinguished cases under which affairs are regulated under constitutional organs (the board of directors of a company) and “outsider” influence of those organs.<sup>225</sup> Where the proper organs of a company merely follow the advice of a parent company or outside advisers, they are still fulfilling their constitutional functions.<sup>226</sup> Thus the court held that Eulalia was not a U.K. resident.<sup>227</sup>

This analysis has become the basic standard of jurisdictions influenced by U.K. law, so that Ireland and Australia have come to follow the *De Beers* line of authority.<sup>228</sup>

#### E. *Alternate Approaches: The People’s Republic of China*

The P.R.C. in 2007 enacted the Enterprise Income Tax Law (“EITL”) to unify their corporate tax regimes.<sup>229</sup> The P.R.C. taxes tax-resident enterprises (“TREs”) on their worldwide income.<sup>230</sup> TREs include both enterprises organized under P.R.C. law and enterprises established under foreign law, in which the management and control is based within the P.R.C.<sup>231</sup> Enterprises established under foreign law are defined as enterprises and other organizations that earn revenue and which are established pursuant to laws of foreign countries (regions).<sup>232</sup>

In contrast to the U.K., the P.R.C. management and control test is a test of active management (i.e. where the “actual

225. *Id.* at 1411.

226. *Id.*

227. *Wood and another v. Holden (Inspector of Taxes)*, [2006] 1 W.L.R. 1393, 1417 (C.A. (Civ. Div.)).

228. *See* Cian Carroll, *Corporate Residence, Taxation and E-Commerce: Domestic and Treaty Law Tests of Company Residence for Tax Purposes in the Context of Modern Communications*, 10 IRISH STUDENT L. REV. 32, 33 (2002), available at <http://www.islr.ie/Reviews/2002/tax.php> (stating Ireland follows the United Kingdom common law tests for company tax residence); *see* Kerrie Sadiq, *Jurisdiction to Tax and the Case for Threshold Reform*, 1 J. AUSTL. TAX TCHRS ASS’N 162, 169 (2005), available at <http://www.austlii.edu.au/au/journals/JATTA/2005/14.html> (inferring Australia follows U.K. common law).

229. *See generally* Enterprise Income Tax Law of the People’s Republic of China (promulgated by the Nat’l People’s Cong., Mar. 16, 2007, effective Jan. 1, 2008), translated at LEHMANLAW.COM, available at [http://www.lehmanlaw.com/fileadmin/lehmanlaw.com/laws\\_regulations/Enterprise\\_Income\\_Tax\\_Law\\_of\\_the\\_PRC\\_LLX\\_03162007\\_.pdf](http://www.lehmanlaw.com/fileadmin/lehmanlaw.com/laws_regulations/Enterprise_Income_Tax_Law_of_the_PRC_LLX_03162007_.pdf) (P.R.C.) [hereinafter EITL].

230. *Id.* at art. 3.

231. *Id.* at art. 2.

232. Implementation Rules of the Enterprise Income Tax Law of the People’s Republic of China (promulgated by the Nat’l People’s Cong., Dec. 6, 2007, effective Jan. 1, 2008), art. 3, translated at LEHMANLAW.COM, available at [http://www.lehmanlaw.com/newsletter/implementation\\_rules\\_of\\_EIT\\_Law\\_of\\_PRC.pdf](http://www.lehmanlaw.com/newsletter/implementation_rules_of_EIT_Law_of_PRC.pdf) (P.R.C.) [hereinafter Implementation Rules].

management” is located).<sup>233</sup> Article 4 of the Implementation Rules of the EITL defines this as “institution as exercise [sic] substantive and comprehensive management and control over an enterprise’s production, operation, staff, accounting, and property, etc.”<sup>234</sup> In other words, the P.R.C. does examine the day-to-day management.<sup>235</sup>

Enactment of the EITL simplified P.R.C. tax law and effectively repealed the “round-trip” incentives that existed formerly.<sup>236</sup> Many offshore vehicles, foreign investment enterprises (“FIEs”), were subject to favorable tax rates compared to domestic enterprises.<sup>237</sup> P.R.C. investors in domestic enterprises found that they could pay at least ten percent more in tax than investing in local businesses through FIEs.<sup>238</sup> To gain favorable tax results, many Chinese investors engaged in “round-tripping,” investing in a FIE that, in turn, invested in Chinese businesses.<sup>239</sup> Although P.R.C. tax law seemed to encourage “round-tripping,” P.R.C. regulatory law created a complex registration process for round-trip investments, all while claiming to give “encouragement, support, and guidance” for such investments.<sup>240</sup>

#### F. *Alternate Approaches: Switzerland*

Switzerland also uses an effective management and control test.<sup>241</sup> Similar to the U.K., Swiss law looks to the location of the top administrative management and where fundamental

233. See EITL, *supra* note 229, at art. 2.

234. Implementation Rules, *supra* note 232, at art. 4.

235. See *id.* (“... such institution as exercise [sic] substantive and comprehensive management and control over an enterprise’s production, operation, staff, accounting and property, etc.”).

236. See Jinyan Li, *The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates*, 8 FLA. TAX REV. 669, 688 (2007).

237. Qingsong (Kevin) Wang, *Tax Incentives Favor Investments in High-Tech Sector*, TAX NOTES INT’L, Apr. 2, 2007, at 28.

238. Li, *supra* note 236, at 688.

239. *Id.*

240. Circular of the State Administration of Foreign Exchange on Relevant Issues Concerning Foreign Exchange Administration of Financing and Return Investments Undertaken by Domestic Residents through Overseas Special-Purpose Vehicles, Hui Fa No. 75, Oct. 21, 2005, available at [http://www.fdi.gov.cn/pub/FDI\\_EN/Laws/ForeignExchangeAdministration/P020060620354537347966.pdf](http://www.fdi.gov.cn/pub/FDI_EN/Laws/ForeignExchangeAdministration/P020060620354537347966.pdf). Article II of Circular 75 required submission of no fewer than six documents to the local foreign exchange offices. *Id.*

241. See Bundesgesetz über die direkte Bundessteuer [Federal Direct Tax Law], Jan. 1, 2009, SR 642.11, art. 50, available at [http://www.admin.ch/ch/d/sr/642\\_11/a50.html](http://www.admin.ch/ch/d/sr/642_11/a50.html).

decisions are made, but Swiss law will also examine the location of management of day-to-day activities.<sup>242</sup>

Under Article 50 of the Federal Direct Tax Law, legal entities are subject to worldwide taxation “due to their affiliation with Switzerland when they have their head office or effective administration in Switzerland.”<sup>243</sup> A Swiss Supreme Court decision in 2003 held that in applying this test, the authorities may disregard the existence of tax haven entities.<sup>244</sup> In this case, where the major portion of the activity of a British Virgin Islands company was developed in Geneva, it was held that the management was in Geneva and the company was subject to full taxation in Switzerland.<sup>245</sup> Then in 2006, another Swiss Supreme Court decision consolidated a Panamanian offshore company with a Swiss company because the Panamanian company “was not in any way independent.”<sup>246</sup>

### G. Policy Considerations

The United States has chosen a worldwide taxation regime and a corporate residence test that relies almost exclusively upon place of incorporation.<sup>247</sup> This has, over the course of the last half-century, created a competition between tax planners and legislators.<sup>248</sup> Although this phenomenon is hardly unique to this area of taxation, or even this country, having the core of this tax system rely on form rather than substance encourages this competition.<sup>249</sup> Separate anti-avoidance regimes now exist for several types of structures such as PFICs for passive investment vehicles, CFCs for foreign corporations with U.S. control and anti-inversion rules for multinationals.<sup>250</sup> Although any tax regime will have its eccentricities, a system that relies on the

242. *See id.*

243. *See id.*

244. PETER R. ALTENBURGER ET AL., 986-3RD T.M., BUSINESS OPERATIONS IN SWITZERLAND ¶ VI(A) (2009).

245. Xavier Oberson, *Corporate Profit Tax*, SWISSNETWORK.COM, Dec. 5, 2005, <http://www.swissnetwork.com/?page=ArticlesByKeyword&keyword=Corporate%20Taxation>.

246. NICOLAS MERLINO, RECENT DEVELOPMENTS ON INTERNATIONAL TAXATION: SWITZERLAND 2006 12 (2006) <http://www.oberson.ch/images/conferences/SNR2006IBAConference.pdf>.

247. *See supra* Part III.

248. *See generally* Pamela A. Fuller, *The Japan-U.S. Income Tax Treaty: Signaling New Norms, Inspiring Reforms, or Just Tweaking Anachronisms in International Tax Policy?*, 40 INT'L LAW. 773 (2006) (discussing briefly the U.S. Congress' response to tax planners use of tax treaties).

249. *See id.* at 819.

250. *See id.* at 787.

determination of control of a corporation will need fewer anti-avoidance rules and will have greater political legitimacy.

With so many choices for defining a domestic corporation, which approach would the U.S. adopt to achieve a more substance-based test? A regime that aspires to look to substance could take a multi-layered approach that examines a broad range of factors. It could start with place of incorporation, as it does now.<sup>251</sup> It could look at where the board of directors meets and exercises authority, as the U.K. does.<sup>252</sup> It could also look to the location of the head office, as Switzerland does,<sup>253</sup> and where general management and control is exercised on a day-to-day basis, as in the P.R.C.<sup>254</sup>

These are by no means the exclusive tests that could be used in a new substance-based regime. A substance-based regime could also examine contractual arrangements that essentially strip a corporation of control of the affairs of the business or place key economic decisions with other persons, as an investment management agreement or a sub-advisory agreement may do. Moreover, a substance-based regime could also look to the location of its highest-paid professionals.

This would have a number of noteworthy effects. First, it could replace regimes that still allow for the deferral of U.S. taxation that careful planning has been able to provide. Particularly with respect to private equity funds, the corporation may be able to avoid PFIC status by having large equity stakes, or it could avoid CFC status with careful structuring of control and economic interests.<sup>255</sup> This type of regime would also provide a more robust anti-avoidance mechanism for multi-nationals. Although existing U.S. multinationals now have a more difficult task in effecting corporate inversions, nothing prevents investors from engineering territorial taxation by establishing a parent corporation in a foreign tax-haven jurisdiction *ab initio*.

What would be the consequences for structuring flows of investments? It would certainly affect outbound and inbound investment differently.<sup>256</sup> For outbound investment, it would make immediately taxable income of U.S. based funds and multinationals operating in foreign corporate solution,

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251. See *supra* Part III.

252. Carroll, *supra* note 228, at 33-35.

253. Federal Direct Tax Law, *supra* note 241.

254. Implementation Rules, *supra* note 232, at art. 4.

255. See *supra* Part II.A-B. (discussing CFCs and PFICs).

256. See generally David P. Hariton, *Equity Derivatives, Inbound Capital and Outbound Withholding Tax*, 60 TAX LAW. 313 (2007).

particularly in tax-haven jurisdictions. This would be offset by either the loss of tax revenue or at least continued deferral with respect to U.S. investors in truly foreign-based funds, e.g., based in London or Amsterdam. But in that respect it would align better with the expectations of the U.S. public.

What would happen to inbound investing? It would change the current master-feeder relationship as offshore feeders would be deemed to be U.S. corporations.<sup>257</sup> That need not act as a significant disincentive to inbound investment, as it would still be possible for foreign investors to avoid an additional layer of taxation on corporate income by structuring vehicles for foreign investors as regulated investment companies. Although this would affect somewhat the current anonymity of foreign investors, those foreign investors truly intent on anonymity would bear the cost of the anonymity, having to form their own shell entities.

When it considered the issue, the American Bar Association Task Force on International Tax Reform noted that a risk of such a rule is that some corporations may relocate management outside the U.S., although in reality, the number of corporations able to do so may be limited.<sup>258</sup> This article would pose as a countervailing consideration of whether those who benefit from U.S. law should be able to avoid worldwide U.S. taxation and notes that those who truly wish to impair their own social networks, relocate their families, be distant from U.S. operations and forego the rule of U.S. law, should be free to do so.

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257. A master-feeder structure consists of two or more “feeder” entities in which investors with various tax attributes invest. *The Investment Company Act Amendments of 1995: Hearing Before the Subcomm. on Telecommunications and Finance Comm. on Commerce*, 110th Cong. 7 (1995) (testimony of Barry P. Barbash, Director, Division of Investment Management, U. S. Securities and Exchange Commission). Foreign and U.S. tax-exempt investors typically invest in a feeder corporation incorporated in such jurisdictions as the Cayman Islands or the British Virgin Islands. See Jerald David August & Lawrence Cohen, *Hedge Funds—Structure, Regulation and Tax Implications*, in TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2008 131, 158 n.30, 159 (PLI Tax Law & Estate Planning, Course Handbook Series No. 815, 2008). The feeder entities, in turn, invest in a “master” partnership that invests in U.S. assets such as publicly-traded stocks or debt instruments. *Id.* at 159.

258. *Task Force on International Tax Reform*, *supra* note 4, at 753. The Task Force wrote the most fruitful approach would be to work within “operative provisions of current tax law” instead of changing the “longstanding place-of-incorporation rule.” *Id.* at 755.



## V. NOTIONAL PRINCIPAL CONTRACTS

A. *Background*

With over \$683 trillion in notional amounts outstanding under derivatives contracts with a gross market value of over \$20 trillion, derivatives have developed an importance in the shadow banking system that is almost inverse to their comprehension.<sup>259</sup> Yet because of the demise of Bear Stearns and insurance giant AIG, the world of derivatives is no longer known only to investment bankers and their advisers.<sup>260</sup> The U.S. government takeover of AIG (now north of \$182 billion),<sup>261</sup> followed by the \$700 billion bailout,<sup>262</sup> has resulted in at least a passing familiarity with the existence of derivatives.

These stories were not even the first major public encounters with the effects of derivatives, with the demise of Long-Term Capital Management and Barings Bank demonstrating their global financial impact.<sup>263</sup> Knowledgeable investors such as Warren Buffett have called derivatives “financial weapons of mass destruction.”<sup>264</sup> In his letter to Berkshire Hathaway investors, he also noted “unless derivatives contracts are

259. See Table 19: *Amounts Outstanding of Over-the-Counter (OTC) Derivatives*, BIS Q. REV., Sept. 2009, at A103, available at <http://www.bis.org/statistics/otcder/dt1920a.pdf>. Credit derivatives alone have an outstanding notional value of \$31.2 trillion. Daniel Gross, *Chicken Feet and Chump Change*, SLATE, Oct. 5, 2009, <http://www.slate.com/id/2231464/>. Note that notional amounts outstanding under derivatives contracts exceed the total value of global financial assets. See INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: FINANCIAL STRESS AND DELEVERAGING MACROFINANCIAL IMPLICATIONS AND POLICY, *supra* note 38, at 185-86.

260. See Joe Ruff, *Buffett Embraces Role of Risk Officer*, OMAHA WORLD HERALD, May 2, 2009, at 04S; Carol J. Loomis, *Derivatives: The Risk that Still Won't Go Away*, FORTUNE, June 23, 2009, at 54 (“We’ll start with reminders of how derivatives contributed to the collapse of Bear Stearns and AIG, in the process delivering a large, and detested, bill to the U.S. taxpayer.”); Brad Stone, *How We Value The Super-Rich*, N.Y. TIMES, Sept. 28, 2008, at WK 5 (“In contrast, the public seems to resent the big boys of Wall Street because they do not appear to have invented anything—unless you count ingenious ways to make more money. Option derivatives are as inexplicable to the general public as particle physics. Richard Fuld of Lehman Brothers, Alan Schwartz of Bear Stearns, and Robert Willumstad of AIG might have tremendous records of innovation. If they do, none of us were told.”).

261. Bloomberg News, *Mexico: A.I.G. Sells Operations*, N.Y. TIMES, June 25, 2009, at B7.

262. The Associated Press, *More Scrutiny of Pay at Troubled Banks*, N.Y. TIMES, July 2, 2009, at B2.

263. See Saul Hansell, *The Collapse of Barings: For Rogue Traders, Yet Another Victim*, N.Y. TIMES, Feb. 28, 1995, at D1; Richard W. Stevenson, *The Collapse of Barings: The Overview; Young Trader's \$29 Billion Bet Brings Down a Venerable Firm*, N.Y. TIMES, Feb. 28, 1995, at A1; Richard W. Stevenson, *Markets Shaken as a British Bank Takes a Big Loss*, N.Y. TIMES, Feb. 27, 1995, at A1.

264. BERKSHIRE HATHAWAY INC., ANNUAL REPORT 15 (2002).

collateralized or guaranteed, their ultimate value also depends on the creditworthiness of the counterparties to them.”<sup>265</sup> In an analysis that proved almost sickeningly prescient, the letter states that derivatives “create a daisy-chain risk that is akin to the risk run by insurers or reinsurers that lay off much of their business with others.”<sup>266</sup> George Soros more recently wrote credit default swaps “are toxic and should be used only by prescription.”<sup>267</sup> He has called for prohibiting the use of these “swaps” to speculate against countries or companies.<sup>268</sup>

Derivatives, of course, refer to financial instruments that have no inherent value of their own, but derive their value by reference to other assets.<sup>269</sup> While options, futures, and forwards are often lumped into this category, the classic derivative is the swap, which is a type of notional principal contract (“NPC”); in this article those terms may be used interchangeably.<sup>270</sup> An NPC involves two counterparties who agree to make payments to each other calculated by reference to some objective financial information such as interest rates or the price of gold.<sup>271</sup>

Although there can be many business reasons for participating in an NPC, certain motivations predominate. One of the most common motivations is protection against risks that a business may have, such as borrower defaults, changes in interest rates, increases in commodities prices, or declines in equity markets.<sup>272</sup> The counterparty essentially provides protection in exchange for regular payments.<sup>273</sup> Some parties may use NPCs to engage in speculation that certain catastrophic events may occur and protection sellers may be required to make substantial payments without the protection buyer having to purchase an asset exposed to the risk.<sup>274</sup> NPCs have also been used to engineer synthetic investments through total return swaps by simulating the cash flows from the investment (e.g., dividends payable) where local regulatory law may prohibit the

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265. *Id.* at 13.

266. *Id.* at 14.

267. George Soros, *The Game Changer*, FIN. TIMES, Jan. 28, 2009, [http://www.ft.com/cms/s/0/49b1654a-ed60-11dd-bd60-0000779fd2ac.html?nclick\\_check=1](http://www.ft.com/cms/s/0/49b1654a-ed60-11dd-bd60-0000779fd2ac.html?nclick_check=1).

268. *Id.*

269. *See Present Law and Analysis Relating to the Tax Treatment of Derivatives Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways & Means*, 110th Cong. 2 (2008) [hereinafter *Tax Treatment of Derivatives*].

270. *See id.* at 19.

271. *See id.* at 1, 7.

272. *See id.* at 4.

273. *See id.* at 6.

274. *See id.* *See generally* Treas. Reg. § 1.446-3 (1993) (providing definitions and basic features of notional principal contracts).

direct investment (as often seen with some Middle Eastern investments) or may restrict the amount of leverage with respect to direct investment in certain securities.<sup>275</sup> With respect to currency swaps, derivatives provide a means for parties to borrow in foreign currencies at rates lower than they could obtain directly from a lending institution.

Other types of NPCs include interest rate caps and floors in which the writer of a contract, in exchange for a premium paid by a purchaser, makes payments only if interest rates rise above or fall below a specified rate.<sup>276</sup> Caps and floors may also be written on commodities or equities indexes.<sup>277</sup>

### B. *The Development of Notional Principal Contract Law*

The tax law of NPCs is almost entirely the creation of the rule-making process and is largely found in Treas. Reg. § 1.446-3, promulgated pursuant to § 446.<sup>278</sup> Section 446 provides merely that a taxpayer may account for income by any method permitted by the IRS.<sup>279</sup> The IRS made its first pronouncement regarding NPCs in 1989 with Notice 89-21 in which the Service announced that it would be issuing proposed regulations to provide for amortization of NPC payments over the life of the NPC.<sup>280</sup> Prior to the issuance of regulations, the IRS stated that it would accept a reasonable method of accounting for NPC payments by the taxpayer if it involved accounting for such payments over the life of the NPC.<sup>281</sup>

Proposed regulations were issued in 1991.<sup>282</sup> The IRS stated its understanding of NPCs as being used “to minimize exposure to adverse changes in interest rates, commodity prices, and currency exchange rates.”<sup>283</sup> The purpose of the regulations was to provide guidance to the taxpayer for the clear reflection of income and deductions from NPCs by prescribing accounting methods intended to reflect the economic substance of NPCs.<sup>284</sup>

275. See Hariton, *supra* note 256, at 348-49.

276. STEVIE D. CONLON & VINCENT M. AQUILINO, CONLON AND AQUILINO: PRINCIPLES OF FINANCIAL DERIVATIVES: U.S. AND INTERNATIONAL TAXATION ¶ A1.04[2][a] (2009).

277. *Id.* ¶ A1.04[1][a].

278. Treas. Reg. § 1.446-3 (1993).

279. I.R.C. § 446(c) (2006).

280. I.R.S. Notice 89-21, 1989-1 C.B. 651.

281. *Id.*

282. Application of Section 446 with Respect to Notional Principal Contracts, 56 Fed. Reg. 31,350 (proposed July 10, 1991) (to be codified at 26 C.F.R. pt. 1).

283. *Id.*

284. *Id.*

At that time, the IRS proposed text of a revenue procedure to provide amortization tables for accounting for non-periodic payments on caps and floors, for instance.<sup>285</sup>

### C. Current Notional Principal Contract Law

The Joint Committee on Taxation recently noted “the tax rules applicable to derivative instruments are not completely developed.”<sup>286</sup> The character rules applicable to swaps, in particular, follow from a series of administrative rulings, many of which have no binding effect.<sup>287</sup> The most important development was the promulgation of final regulations in 1993 that substantially adopted the proposed regulations.<sup>288</sup>

The purpose of the new regime was to “enable clear reflection of income and deductions from [NPCs] by prescribing . . . methods” that reflected the Service’s view of the economic substance.<sup>289</sup> NPCs would exclude “Section 1256(b)” contracts, futures, forwards, and options.<sup>290</sup> The new regulations defined NPCs as agreements by a party with another to make payments at set intervals, “calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.”<sup>291</sup> Because the notional amounts are never actually paid, the payments are not to be considered for the use or forbearance of money and could not be considered interest.<sup>292</sup>

Instead, payments made pursuant to NPCs would be classified as periodic payments, non-periodic payments, or termination payments.<sup>293</sup> Periodic payments are payments made at intervals of one year or less and calculated by reference to the notional and the relevant index.<sup>294</sup> For periodic payments, the recipient is required to recognize the ratable daily portion.<sup>295</sup>

The specified index can be (1) a fixed rate, price, or amount; (2) such a fixed rate, price, or amount in one or more periods followed by different fixed rates, prices, or amounts; (3) an index based on objective financial information; or (4) an interest rate

285. *Id.*

286. *Tax Treatment of Derivatives*, *supra* note 269, at 14.

287. *See id.* at 19.

288. *See* T.D. 8491, 1993-2 C.B. 215.

289. Treas. Reg. § 1.446-3(b) (1993).

290. *Id.* § 1.446-3(c)(1)(ii).

291. *Id.* § 1.446-3(c)(1)(i).

292. *Id.* § 1.446-3(f)(2)(iii)(B).

293. *See id.* §§ 1.446-3(e)(1)-(h)(1); *id.* § 1.446-3(c)(2)(i-iv).

294. *See id.* § 1.446-3(e)(1).

295. *See* Treas. Reg. § 1.446-3(e)(2)(i) (1993).

index.<sup>296</sup> “[O]bjective financial information is any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties’ circumstances.”<sup>297</sup>

A termination payment is a payment made to extinguish or assign all or part of the rights under an NPC.<sup>298</sup> Termination payments, unlike periodic and nonperiodic payments, are recognized in full in the year of payment.<sup>299</sup> A gain or loss from a termination payment is treated as a gain or loss from the termination of an NPC.<sup>300</sup> Thus, such a payment should result in a capital gain or loss.<sup>301</sup> A party recognizing income from a termination payment must also recognize all other income from payments that have been made but not yet recognized.<sup>302</sup>

A nonperiodic payment is a payment under an NPC that is neither a periodic payment nor a termination payment, such as the payment of a premium for a cap or a floor.<sup>303</sup> Taxpayers must recognize the daily portion of nonperiodic payments as spread out over the term of the NPC.<sup>304</sup> This can be done by amortizing an upfront payment over the remaining term of the NPC or by “treating the [NPC] as if it provided for a single upfront payment . . . and a loan between the parties.”<sup>305</sup> If the nonperiodic payments are significant, the arrangement is to be treated as two transactions: a swap and a loan.<sup>306</sup>

Although the regulations do not dictate the character of periodic and nonperiodic payments as either capital gain or ordinary income, commentators have written that case law and administrative guidance favors ordinary income treatment because such payments made pursuant to an NPC are not from a sale or exchange.<sup>307</sup> The IRS provided nonbinding guidance regarding periodic and nonperiodic payments in interest swaps in Priv. Ltr. Rul. 98-24-026.<sup>308</sup> Periodic payments were analogized

296. See *id.* § 1.446-3(c)(2).

297. *Id.* § 1.446-3(c)(4)(ii).

298. See *id.* § 1.446-3(h)(1).

299. See *id.* § 1.446-3(h)(2).

300. See Treas. Reg. § 1.1234-1(a) (1979).

301. See *id.* § 1.1234-1(a); I.R.S. Tech. Adv. Mem. 43043-96 (July 25, 1997).

302. See Treas. Reg. § 1.446-3(h)(2) (1993); I.R.S. Tech. Adv. Mem. 43043-96 (July 25, 1997).

303. See Treas. Reg. § 1.446-3(f)(1) (1993).

304. See *id.* § 1.446-3(f)(2)(i).

305. *Id.* § 1.446-3(f)(2)(iii).

306. See *id.* § 1.446-3(g)(4).

307. See KEVIN KEYES, FEDERAL TAXATION OF FINANCIAL INSTRUMENTS & TRANSACTIONS § 14.04[3][a][i] (2009); I.R.S. Tech. Adv. Mem. 97-30-007 (July 25, 1997).

308. See I.R.S. Priv. Ltr. Rul. 98-24-026 (June 12, 1998).

to dividends on stock and interest in securities.<sup>309</sup> The IRS noted that with periodic and nonperiodic payments, there is no sale or exchange of a capital asset.<sup>310</sup> Two years later, the IRS followed up with a similar ruling regarding payments under commodities swaps.<sup>311</sup>

Payments to foreign persons under NPCs do not currently appear to be subject to FDAP withholding tax. In Notice 87-4, the IRS stated that it had no position on whether swap payments would be considered FDAP income.<sup>312</sup> For most foreign taxpayers, this gray area was rendered moot by Treas. Reg. § 1.863-7(b), which states that payments on NPCs are sourced to the residence of the recipients, making such payments not subject to withholding as long as they are not effectively connected with a U.S. trade or business.<sup>313</sup> Because the FDAP withholding tax applies to payment of items of income from sources within the U.S., it also created an incentive to structure equity investments that yield U.S. source dividend income as NPCs.<sup>314</sup>

Although many NPCs are entered into to insure against business or financial risk, they do not appear to be taxed as insurance contracts. This is because insurance has been defined to require both risk shifting and risk distribution.<sup>315</sup> Risk distribution requires making use of the law of large numbers so that one claim will not exceed premiums received.<sup>316</sup> Otherwise, the insured is paying for its own risk.<sup>317</sup> Because protection sellers are not spreading the risk of loss across a large group, NPCs do not seem to meet the second prong.<sup>318</sup>

If NPCs did meet the definition of insurance, the payments made by the protection buyers would be taxed as insurance premiums at ordinary income tax rates.<sup>319</sup> When claims are paid on insurance policies, the insurance proceeds are frequently tax-

309. *See id.*

310. *See id.*

311. *See* I.R.S. Priv. Ltr. Rul. 97-30-007 (Apr. 10, 1997).

312. *See* I.R.S. Notice 87-4, 1987-1 C.B. 416.

313. *See* Treas. Reg. § 1.863-7(b) (1991).

314. *See* Gregory May, *Flying on Instruments: Synthetic Instruments and Withholding Tax Avoidance*, 73 TAX NOTES 1225, 1227 (1996). This has been the subject of increasing scrutiny by the I.R.S.

315. *See* Rev. Rul. 05-40, 2005-2 C.B. 4; Rev. Rul. 02-90, 2002-2 C.B. 985.

316. *See* Rev. Rul. 05-40, 2005-2 C.B. 4; Rev. Rul. 02-90, 2002-2 C.B. 985.

317. *See id.* For insurance of financial risks, it should be noted that when one insured has a claim, many other insureds will also have a claim. This differs from auto insurance where all car owners are unlikely to experience collisions at the same time.

318. *See* Rev. Rul. 05-40, 2005-2 C.B. 4.

319. *See* I.R.C. § 61(a)(10) (2006).

free to the insurance purchaser.<sup>320</sup> Outbound payments of insurance premiums are subject to FDAP withholding at 30% plus an excise tax of 1% for reinsurance and life insurance and 4% for property and casualty insurance premiums.<sup>321</sup>

#### D. Policy Considerations

For an industry that is responsible for \$20 trillion in transactions annually,<sup>322</sup> it is unusual that Congress has never established a policy regarding how NPCs should be treated, thus leaving courts and the Treasury department to fill the gap. Although the judicial and executive branches have only acted according to their responsibilities, they lack the authority to carry out the greater responsibility of regulating these transactions and taxing them according to their true business purposes.

This has created the possibility and opportunity to use NPCs for amoebic shapeshifting. It may be asked what public interest is served by permitting a vast vacuum in the tax law that allows one financial instrument to be engineered to achieve a menu of potential tax results. Although tax law cannot make up for the regulation that other bodies, such as the Securities and Exchange Commission, the Commodities Futures Trading Commission, or the Federal Reserve, should have carried out or should be permitted to carry out, it can either contribute to better regulation or further the free-for-all that has existed. Tax law may be enlisted to help create some clarity about how we think about NPCs.

The place to start fashioning a public policy for NPCs is to clarify their purpose. As part of the reporting on NPCs, taxpayers could be required to disclose the purpose of the NPC. The main purposes would likely be reported as either to exchange risks or for one party to purchase protection against risk. Obtaining this information creates the ability to treat transactions in which one party purchases risk protection from another as insurance transactions while leaving under the current NPC regime only transactions where both parties have exposures against which they are exchanging risks (e.g., loan

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320. See I.R.C. § 101(a)(1) (2006 & Supp. 2009) (death benefits under life insurance contract not taxable); I.R.C. § 165(l) (2006 & Supp. 2009) (insurance proceeds received by financial institution attributable to deposit loss not taxable). *But see* I.R.C. § 72(a) (2006 & Supp. 2009) (proceeds received as an annuity under a life insurance contract are specifically included in gross income).

321. See I.R.C. § 871(a)(1)(A)-(B) (2006 & Supp. 2009); I.R.C. § 4371 (2006).

322. See *Statistical Annex*, BIS Q. REV., Sept. 2009, at A7, available at [http://www.bis.org/publ/qtrpdf/r\\_qa0909.pdf](http://www.bis.org/publ/qtrpdf/r_qa0909.pdf).

portfolios with different profiles or currency swaps). The reason that NPCs are currently not treated as insurance is because an insurance company that failed to engage in risk spreading would be considered to have done insurance badly.<sup>323</sup> Unfortunately, this has only contributed to the idea that selling protection through NPCs is not insurance, an idea that should be reconsidered in light of the demise of AIG and several investment banks.

The role of protection buyers should also be examined. For parties with a risk that must be hedged, NPCs are sensible investments and such parties should receive proceeds from these instruments tax-free. But these parties are in a different position than those who enter an NPC in order to “bet” on events such as defaults or declines in indexes without having an actual interest in the asset that the NPC is designed to protect. So that tax policy does not encourage these investments, parties who purchase protection without having an insurable interest could be subject to an excise tax that to some significant degree divests them of the benefits of these instruments.

## VI. FINANCIAL TRANSACTIONS TAX

### A. *Background*

In addition to the consideration of aligning existing U.S. federal income tax laws with public policy goals as discussed above, attention may also turn to other durable means of raising revenue. In considering new means of raising revenue, particularly during a severe economic downturn, ideally new forms of taxation should not directly impact individual taxpayers or operating businesses.

Financial transaction taxes (“FTTs”) were suggested by the notable economist James Tobin in 1978.<sup>324</sup> More recently, Dean Baker wrote a monograph in 2008 advocating an FTT.<sup>325</sup> Baker

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323. One critic referred to some NPCs as “I-can’t-believe-it’s-not-insurance”. *American International Group’s Impact on the Global Economy: Before, During, and After Federal Intervention: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the Comm. On Financial Services*, 111th Cong. 31 (2009) (statement of Congressman Gary Ackerman).

324. See Robert Pollin, Dean Baker & Marc Schaberg, *Securities Transaction Taxes for U.S. Financial Markets 2* (Pol. Econ. Res. Inst., Working Paper No. 20, 2001), available at [http://www.peri.umass.edu/fileadmin/pdf/working\\_papers/working\\_papers\\_1-50/WP20.pdf](http://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_1-50/WP20.pdf).

325. See Dean Baker, *The Benefits of a Financial Transaction Tax 1* (2008) (unpublished article, available on the Ctr. for Econ. and Pol’y Res. website), <http://www.cepr.net/documents/publications/financial-transactions-tax-2008-12.pdf>.



estimated, based on trading volume from the year 2000, that the United States could raise \$100 billion a year in taxes from a modest FTT, even if the tax acted as a disincentive to trading.<sup>326</sup> These effects, however, would probably not be large enough to materially impact the long-term investor.<sup>327</sup>

The 2008 publication follows up on the 2001 monograph *Securities Transaction Taxes for U.S. Financial Markets*.<sup>328</sup> The 2001 monograph notes that political proposals for a FTT date back at least to 1987 when a FTT was proposed by House Speaker Jim Wright after the 1987 stock market crash.<sup>329</sup> Lawrence Summers also proposed such a tax in 1989,<sup>330</sup> long before he became Clinton's Treasury Secretary and a senior economic advisor to President Obama.<sup>331</sup>

The FTT, an updated stamp tax, is in fact one of the world's oldest forms of taxation, dating back to Emperor Justinian of the Byzantine Empire, and in more modern times to the Netherlands in 1624.<sup>332</sup> The stamp tax also has an ignominious role in American history, cited as one of a series of grievances by the revolutionaries who fought for American independence from the Great Britain.<sup>333</sup>

The idea of the FTT is that it acts as a tax on volatility; it penalizes short-term transactions while not materially affecting long-term investments.<sup>334</sup> Greater churning by investment funds would be accompanied by a greater FTT paid, which would act as a disincentive to speculation.<sup>335</sup> Meanwhile, because it is a tax that does not land on income, it is progressive.<sup>336</sup> It also does not tax business operations or the profits therefrom and therefore should not affect the most direct job-generating activities.<sup>337</sup>

FTTs have not only been criticized as being alternately ineffective in reducing volatility, but also as being too effective,

326. Bob Herbert, *Where the Money Is*, N.Y. TIMES, Jan. 12, 2009, at A25.

327. See Pollin et al., *supra* note 324, at 14.

328. See *id.*

329. See *id.* at 1-2, 22.

330. See Lawrence H. Summers & Victoria P. Summers, *When Financial Markets Work Too Well: A Cautious Case For a Securities Transactions Tax*, 3 J. OF FIN. SERVS. RES. 261, 263 (1989).

331. See National Economic Council: Chair, <http://www.whitehouse.gov/administration/eop/nec/chair/> (last visited Oct. 23, 2009).

332. See HM REVENUE & CUSTOMS, STAMP TAXES MANUAL ¶¶ 1.32, 1.33, <http://www.hmrc.gov.uk/so/manual.pdf> (last visited Oct. 23, 2009).

333. See *id.* ¶ 1.37.

334. See Summers, *supra* note 330, at 263.

335. See *id.*

336. See *id.* at 285.

337. See Pollin et al., *supra* note 324, at 5.

since they raise the cost of capital while inviting attempts to evade the FTT by using other instruments not subject to the FTT.<sup>338</sup> Economic studies have also provided confirmation that FTTs have a detrimental effect on share prices.<sup>339</sup>

This section will consider some design issues with respect to a financial transactions tax, but first it is worth examining other similar taxes.

### B. *The United Kingdom*

The United Kingdom imposes a stamp duty on instruments that purport to transfer property, including stock or marketable securities.<sup>340</sup> The tax imposed is 0.5% of gross consideration.<sup>341</sup> The main sanction for failure to pay a stamp tax is that unstamped documents are not considered valid for judicial and administrative purposes, which is a significant impairment on title for a purchaser.<sup>342</sup>

Because a stamp duty is a tax on documents, this tax has created a potential gap for taxation of paperless transactions, something that is a significant issue now that most securities transactions occur over computer networks.<sup>343</sup> For this reason, the Stamp Duty Reserve Tax (“SDRT”) was introduced in 1986.<sup>344</sup> The SDRT imposes a tax of 0.5% of the consideration paid for “chargeable securities.”<sup>345</sup> Chargeable securities include shares in U.K. companies, shares in foreign companies registered in the U.K., options on such shares, and units in unit trusts.<sup>346</sup> Exceptions to stamp tax and SDRT are provided to charities.<sup>347</sup>

The SDRT is imposed at the rate of 0.5% on the value of consideration paid for chargeable securities.<sup>348</sup> A higher rate of 1.5% applies to transfers of securities into depository receipt shares and clearance services.<sup>349</sup> Chargeable securities include stocks, shares, and loan capital issued or raised by U.K.

338. *See id.* at 13.

339. *See, e.g.,* Steve Bond, Mike Hawkins & Alexander Klemm, *Stamp Duty on Shares and Its Effect on Share Prices* (Inst. For Fiscal Stud., Working Paper No. W04/11, 2004), <http://www.ifs.org.uk/wps/wp0411.pdf>.

340. *See* STAMP TAXES MANUAL, *supra* note 332, ¶¶ 1.6, 4.25.

341. *See id.* ¶ 1.10.

342. *See* Stamp Act, 1891, 54 & 55 Vict., c.39, § 14(4) (U.K.).

343. *See* STAMP TAXES MANUAL, *supra* note 332, ¶ 1.18.

344. *See id.*

345. *See id.* ¶ 1.21.

346. *See id.* ¶ 1.23.

347. *See id.* ¶ 1.24.

348. *See id.* ¶ 10.4.

349. *See* STAMP TAXES MANUAL, *supra* note 332, ¶ 10.6.

incorporated entities, interests in such securities, securities issued or raised by entities incorporated outside the U.K. and raised in the U.K. or paired with shares of a U.K. entity, and units of unit trusts.<sup>350</sup> The consideration paid is considered to be money and the market value of any other property used to purchase chargeable securities.<sup>351</sup>

The SDRT is charged on an agreement, regardless of whether the agreement is oral or written.<sup>352</sup> The tax is collected through the CREST system, an electronic settlements system that provides for movement of shares and payments and sends payments to the HMRC via a direct electronic link.<sup>353</sup>

It remains to be seen how the SDRT will be affected by the October 2009 ruling of the European Court of Justice (“ECJ”) that the SDRT as currently enacted violates provisions of European Community law.<sup>354</sup> In particular, the imposition of the SDRT upon issuance of shares into European clearance systems was found to have violated a Council Directive concerning indirect taxes on the raising of capital.<sup>355</sup> This represents the creation of a potential route for avoiding the SDRT by routing U.K. securities destined for the U.S. investment market through the European Union. It also should serve as a warning to sovereign states to be careful what authority over their tax regimes they assign to supranational bodies.<sup>356</sup>

### C. Switzerland

Under the Swiss Federal Stamp Tax Act (“FSTA”), Switzerland imposes a stamp duty on the issuance of share capital of a company in excess of one million Swiss francs, including shares in LLCs, participation certificates, profit sharing certificates, debentures, and money market papers.<sup>357</sup>

350. *See id.* ¶ 11.7.

351. *See id.* ¶ 11.9.

352. *See id.* ¶ 11.14.

353. *See* HM Revenue & Customs: Stamp Duty Reserve Tax, <http://www.hmrc.gov.uk/so/sdrt/index.htm> (last viewed Oct. 23, 2009).

354. HSBC Holdings plc v. Comm’rs of Her Majesty’s Revenue & Customs, Case C-569/07, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62007J0569:EN:HTML>, ¶ 39 (Ct. of Justice of the Eur. Communities, Oct. 1, 2009).

355. *Id.* ¶ 33-39.

356. *See* William M. Funk, *The Thirty-Years Tax War*, 24 TAX NOTES INT’L 65 (Oct. 1, 2001) (discussing repeated rulings of the World Trade Organization against the United States’ foreign sales corporation and extraterritorial income regimes).

357. *See* Swiss Federal Stamp Tax Legislation: English Translation of Act and Ordinances, June 1, 2007, art. 1a, 6a, available at <http://www.wpp.ch/publications/482.pdf>.

The issuance tax is imposed at the rate of one percent of the greater of consideration or par.<sup>358</sup>

A securities transfer tax applies to sale or exchange of such instruments when the issuer is Swiss, if one of the parties to the transaction is Swiss, or if a Swiss securities dealer is used as an intermediary.<sup>359</sup> The definition of securities dealer includes (1) banks and financial institutions, (2) business entities whose principal activity is purchase and sale of securities for their own account, (3) investment fund managers, and (4) entities owning taxable securities with a book value of more than ten million Swiss francs.<sup>360</sup> The current tax rate is 0.15% on securities issued by a Swiss person and 0.3% by a foreign issuer.<sup>361</sup> The tax is based on the consideration paid, which is the money and the fair market value of other property paid.<sup>362</sup> The Stamp tax is also imposed on insurance premiums.<sup>363</sup>

#### D. Policy Considerations

The U.K. probably has the most extensive experience with the FTT in the modern era;<sup>364</sup> therefore, any attempt to implement a FTT would be likely to be based on the U.K. model, particularly the mechanism of electronic settlement and the sanction of making payment a condition of evidence of transfer.

The British model has the flexibility to be modified to include elements of other models such as the Swiss model and even the New York City Real Property Transfer Tax.<sup>365</sup> The model can also be modified to address policy concerns about certain disincentives. In Baker's proposal, he suggests covering as broad a range of instruments as possible, including debt and interest rate swaps, to help prevent avoidance by use of one financial instrument over another.<sup>366</sup>

Baker does note some disincentive to trade in a stamp tax jurisdiction but states that London remains a center of

358. See *id.* at art. 8(1).

359. See *id.* at art. 1, 13.

360. See *id.* at art. 13(3).

361. See *id.* at art. 16(1); Heini Rüdisühli, *The Benefits of Swiss Companies in International Tax Planning*, 44 TAX NOTES INT'L 619 (Nov. 20, 2006).

362. See Swiss Federal Stamp Tax Act art. 16(2).

363. See *id.* at art. 21-26.

364. See generally Baker, *supra* note 325.

365. The New York Real Property Transfer Tax has extensive anti-avoidance rules regarding the transfer of property by means of transferring interests in entities that own property in New York City. See Jeffrey C. Glickman & Clark R. Calhoun, *The "States" of the Federal Common Law Doctrines*, 61 TAX. LAW. 1181, 1214 (2008).

366. See Baker, *supra* note 325, at 2.

international finance.<sup>367</sup> It may be possible to diminish this disincentive through careful structuring. To avoid the prospect of large corporations choosing not to participate in U.S. exchanges, the FTT can be set at a higher rate for transfers of securities of U.S. issuers on foreign exchanges, with the U.S. issuer responsible for payment of tax on such transfers.<sup>368</sup> This could be particularly robust if coupled with suggested changes in the definition of a U.S. corporation.

It is important for such a tax to be durable and not subject to avoidance by routing through other markets in the way that the SDRT may be in the wake of the ECJ decision. Otherwise, the FTT risks having the design flaw warned of by *The Economist*, that “it would be unworkable unless all governments signed up to it.”<sup>369</sup>

Although a FTT should not fall on most U.S. taxpayers, the FTT design can be tweaked further to protect the overwhelming majority of U.S. taxpayers. Exempting transfers below a cumulative annual threshold such as \$250,000 would still raise significant revenues from investors representing large pools of capital while protecting taxpayers who may be liquidating investments to pay for a down payment on a home or for unexpected medical expenses. A further adjustment would be to credit investment funds for the ratable portion of their investment vehicles owned by pension funds. Either of these would further increase the progressivity of an already progressive tax.

## VII. CONCLUSION

This article does not pretend to propose an exhaustive or systematic set of reforms of taxation of the investment management industry or of incentives for investors. Rather, this article has focused on some of the leading issues and imbalances within the system with an eye toward where financial and social outcomes may be directed. To discuss all tax policies, all current financial issues, and all consequences is a much larger undertaking than can be addressed in one or a series of articles.

What can be done is to examine where taxation of the largest and most consequential pools of capital has gone off-track from what would be the rational expectations of an observer with no vested interest in the status quo. It took many years and the

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367. See *id.* at 1.

368. See *id.*

369. *The Wrong Tool for the Job*, *ECONOMIST*, Sept. 19, 2009, at 15-18.

influence of countless players in the tax and financial system to reach this state of affairs, proving that the worst mistakes we make are the ones we make collectively.

Realigning tax and financial policy will require many inputs from many parties, including sources that are unexpected and still unknown at this time. But the process can only start by asking knowledgeable yet basic questions about what sort of governance we wish to have. As policy-makers feel their way through this period, a different tax environment may yet emerge that will require new thinking so that taxpayers can achieve the best results in their roles as private economic actors and public citizens.