

## CROSS-BORDER TAX ARBITRAGE

The following are common situations and transactions involving the tax systems of the United States and a foreign country (let's call it Elbonia). Assume that X is a corporate taxpayer in the United States, and that Y is an entity formed outside the United States that may own X, or be owned by X, or be independent of X, depending on the circumstances.

	<u>United States</u>	<u>Elbonia</u>
1) <u>Dual Resident Corporation</u>	X is organized in the United States and hence resident in the United States under its tax laws	X is managed and controlled in Elbonia and hence resident in Elbonia under its tax laws

Tax benefits: losses or credits of X are potentially available to reduce taxes of related parties under consolidated return or group relief rules in both the United States and Elbonia

2) <u>Hybrid Instrument</u>	X extends funds to Y under an instrument considered equity under the tax laws of the United States	The instrument is debt under the tax laws of Elbonia
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Tax benefits: foreign tax credits or dividends received deductions for X in the United States and interest deductions for Y in Elbonia

	X borrows funds from Y under an instrument considered debt under the tax laws of the United States	The instrument is equity under the tax laws of Elbonia
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Tax benefits: deductible interest for X in the United States and dividends for Y that are either exempt or that make foreign tax credits available to Y in Elbonia

3) <u>Hybrid Branch</u>	Y, which is owned by X, is transparent (nonexistent) under the tax laws of the United States	Y is non-transparent under the tax laws of Elbonia
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Tax benefits: the results of Y's operations, including losses and credits, are attributable to X, and payments by Y to X (or vice versa) have no consequences under the tax laws of the United States; the results of Y's operations remain confined within Y insofar as the tax laws of Elbonia are concerned and payments between X and Y have Elbonian tax effects

- 4)      Reverse Hybrid                      Y is owned by X and is non-transparent under the tax laws of the United States                      Y is transparent under the tax laws of Elbonia

Tax benefits: deferral of tax on Y's income in the United States, while foreign tax credits are (arguably) claimable by X in the United States for the Elbonian tax on Y's income

X is owned by Y and a taxable corporation under the tax laws of the United States                      X is transparent under the tax laws of Elbonia

Tax benefits: dividends paid to X by another U.S. corporation are subject to no or reduced taxation in the United States by reason of the dividends received deduction, while foreign tax credits or exemption flow through to Y under the tax laws of Elbonia

- 5)      Repo                                      X sells a security to Y with a contemporaneous agreement to repurchase the security at a designated future date                                      Under the tax laws of Elbonia the transaction is viewed as a sale by X, with an agreement to repurchase at a subsequent date

Tax benefits: the transaction is a secured financing under the tax laws of the United States, so distributions on the security belong to X and amounts paid by X to Y in excess of the original sale price are deductible interest; but ownership of the security is transferred to Y for the duration of the transaction under the tax laws of Elbonia, so credits or exemption are available in Elbonia for distributions on the security

- 6)      Taxpayer Use of Arm's-Length Method                      Having bought a widget from Y at a cash price of 25, X reports the arm's-length price as 35 under the tax laws of the United States                      Y reports a price of 25 under the tax laws of Elbonia

Tax benefits: a cost of goods of 35 for X in the United States, but a sale price of 25 reported by Y in Elbonia; and a transfer of 10 from Y to X, with attendant tax consequences, under the tax laws of the United States

Having borrowed from Y at a zero rate of interest, X reports deductible interest at an arm's-length rate under the tax laws of the United States                      Y reports no income under the tax laws of Elbonia

Tax benefits: interest deduction for X in the United States, but zero income to Y in Elbonia

QUESTIONS:

- A) Is there commonality among these situations in legal/policy terms?
- B) Can any of these situations be satisfactorily resolved by “substance-over-form” analysis (an “anodyne for the pain of thinking” per L. Hand, J.)?
- C) Is there application here of the body of law prohibiting taxpayers from disavowing the form of their transactions? See, *e.g.*, Taiyo Hawaii Company, Ltd., 108 T.C. 590 (1997).
- D) Is there a tax policy problem here? If so, what is it?

OBSERVATIONS:

- A) There is no general U.S. rule or policy relating to cross-border tax arbitrage.
- B) There may be no reason for such a general rule, and it would be difficult to administer a general rule.
- C) There are specific rules in U.S. law aimed at particular arbitrage situations. See, for example, section 1503(d) of the Internal Revenue Code; Treasury Regulation § 1.901-2T(e)(5)(iv); Proposed Treasury Regulation § 1.901-2(f).
- D) Certain policies expressed in U.S. law presuppose and depend upon the tax laws of other countries (for example, section 954(c)(3)(A)); these policies may be thwarted by cross-border tax arbitrage.
- E) Arbitrage within a single tax system is arguably more problematic than cross-border arbitrage.

H. David Rosenbloom  
September 21, 2008