FINANCING FOREIGN OPERATIONS THROUGH DOMESTIC FINANCE SUBSIDIARIES

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WITH the advent of serious United States balance of payments problems in recent years, domestic companies have been under increased governmental pressure to turn abroad to finance their foreign operations.[1] During the period of the Commerce Department's voluntary control program,[2] the source of foreign funds most frequently tapped was the Eurodollar[3] deposits held by foreign branches of domestic banks. With the imposition of the mandatory balance of payments controls on January 1, 1968,[4] United States companies faced a

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1 For brief summaries of the United States balance of payments programs prior to the present Foreign Direct Investment Program, see Lancaster, *The Foreign Direct Investment Regulations: A Look at Ad Hoc Rulemaking,* 55 VA. L. REV. 83, 84-87 (1969) [hereinafter cited as Lancaster, *FDIR*]; Note, *The Foreign Direct Investment Program: An Analysis and Critique,* 55 VA. L. REV. 139, 139-41 (1969) [hereinafter cited as Note, *FDIP*]. For a table reflecting the growing U.S. deficit from 1950 to 1966, see *id.* at 143 n.23.

2 The voluntary cooperation program was announced by President Johnson on February 10, 1965. Special Message to the Congress on International Balance of Payments, 1 PUBLIC PAPERS OF THE PRESIDENTS: LYNDON B. JOHNSON 1965, at 170-71. Under this program of voluntary guidelines administered by the Commerce Department, American businesses having foreign investments of more than ten million dollars at the end of 1964 were asked to

> achieve during 1965 an average improvement of fifteen to twenty percent in the direct investment portion of the balance of payments account, to reduce foreign-held short-term assets, and to furnish balance of payments information to the Department of Commerce.

Note, *FDIP,* at 141, *citing* Letter from Secretary of Commerce John T. Connor to Selected Business Leaders, March 12, 1965, on file in the office of the *Virginia Law Review.* Approximately 700 corporations participated in the program before it was superseded by the mandatory controls on January 1, 1968.

3 A Eurodollar is simply a United States dollar deposited in a bank outside the United States. For a further discussion, see BUSINESS INTERNATIONAL CORPORATION, FINANCING FOREIGN OPERATIONS 217-18 (1969) [hereinafter cited as FFO].

4 On this date President Johnson issued an Executive Order which prohibited certain persons

> except as expressly authorized by the Secretary of Commerce, from engaging in any transaction involving a direct or indirect transfer of capital to or within any foreign country or to any national thereof outside the United States.

Exec. Order No. 11387, Governing Certain Capital Transfers Abroad, Jan. 3, 1968, 33 Fed. Reg. 47 (1968). On the same day, the Secretary of Commerce exercised his

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need for larger amounts of foreign funds,[5] as well as significantly longer term capital.[6] Because they were required to rely largely on demand deposits for operating money, the foreign branches of United States banks were unable to commit themselves to debt obligations with terms in excess of five to seven years. Furthermore, the borrower could rarely be assured of a fixed interest rate for longer than six months.[7] As a result, a substantial number of investors were forced to look outside the banking community for long-term foreign funds.[8]

The most popular way of raising the requisite capital has been by public distribution of bonds abroad, normally denominated in dollars. Financing of this nature began on a small scale as early as 1965, but it was not until 1968 that it came into full blossom.[9] During that year foreign investors found these securities, referred to as Eurobonds, to be extremely attractive and some 70 issues were floated, yielding total proceeds of $1,558.4 billion.[10] A typical bond matured in 15 or 20 years and was convertible. The conversion privilege was normally delayed for six months to a year and the conversion price was set at a figure from five to fifteen percent above the price of the underlying common at the time of issuance, depending largely on the reputation of the bor-

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delegated authority and promulgated the Foreign Direct Investment Regulations, now found at 15 C.F.R. §§ 1000.101-.1301 (1969). For descriptions of the broad goals as well as the specific provisions of these regulations, see Kingson, *Investment in Western Europe Under the Foreign Direct Investment Regulations: Repatriation, Taxes and Borrowings*, 69 COLUM. L. REV. 1 (1969) [hereinafter cited as Kingson, *Investment*]; Lancaster, *FDIR*, at 87-99; Note, *FDIP*, at 144-47.

[5] To compensate for revenues that became unavailable to foreign subsidiaries, firms could make long-term borrowings abroad. *See* Kingson, *Investment*, at 28-33.

[6] A foreign borrowing must be "long-term" (minimum of one year maturity) if it is to be deducted from net transfers of capital. 15 C.F.R. § 1000.324(a) (1969); Kingson, *Investment*, at 28. These are, however, limitations on repayment which can force direct investors to maintain their foreign indebtedness indefinitely. See text at note 87 *infra*.

[7] *See* FFO at 219-20.

[8] In addition to the shortage of long-term funds available from foreign branches of United States banks and the fluctuating interest rate, the borrowing problems of domestic investors were further complicated by the new FDIR, see note 6 *supra*, and the accompanying tax disadvantages for the banks. *See* Kingson, *Investment*, at 31-33.

[9] American corporations offered Eurobonds totaling more than 295 million dollars in 1965, 434 million dollars in 1966, 528 million dollars in 1967 and 1.324 billion dollars in the first half of 1968. CHASE MANHATTAN BANK, EURO-DOLLAR FINANCING 8 (Sept. 1968).

[10] FFO at 233, 236a-f.

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rower. The convertible feature permitted interest rates to remain from one and one-half to two points below the rates on straight debt.[11]

Borrowing foreign funds abroad from the general public was not itself a difficult problem; however, this kind of financing created tax obstacles, the solution of which created additional tax and securities problems. These difficulties are discussed below in two separate sections. A third section analyzes the ramifications of the Foreign Direct Investment Regulations.

Tax Aspects of Foreign Borrowing

The Withholding Problem

When United States companies borrowed from foreign branches of domestic banks, they were dealing with United States persons, notwithstanding their nonresident status, and were therefore not obligated to withhold income tax on interest payments.[12] Interest paid to nonresident aliens or foreign corporations who purchased the convertible Eurobonds, however, is normally subject to withholding and tax at the rate of 30 percent[13] or at lower treaty provision rates, if applicable.[14]

Regardless of the withholding rate, the cost of any taxes withheld on interest payments would have to be borne by the American borrower because purchasers of convertible debentures are frequently not taxed in their own countries and are seldom able to take advantage of foreign tax credits. If withholding were imposed, therefore, the in-

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[11] *Id.* at 227-36. For an excellent explanation of Eurodollar financing, see Chase Manhattan Bank, Euro-dollar Financing (Sept. 1968).

[12] Sections 1441 and 1442 of the Internal Revenue Code do not require the withholding of federal income tax on such income. See note 13 *infra*.

[13] Int. Rev. Code of 1954, §§ 871, 881. These sections impose a tax of 30% of the amount of interest received from sources within the United States by a nonresident individual or foreign corporation. Sections 1441(a) (nonresident alien individuals) and 1442(a) (foreign corporations) supplement these two provisions by requiring that the taxes imposed be withheld at the time the interest is paid.

[14] Residents of foreign countries having tax treaties with the United States and corporations which were formed in such countries may be relieved of all or part of the tax liabilities imposed by Int. Rev. Code of 1954, §§ 871, 881. Int. Rev. Code of 1954, § 894; Treas. Regs. §§ 1.871-7(e) (1957) (nonresident aliens), 1.881-2(f) (1957) (foreign corporations). Similarly, the amount of tax to be withheld is reduced commensurate with the amount of the reduction in the tax imposed. Treas. Reg. §§ 1.1441-1, 1.1442-1 (1956). For an example of such a tax treaty, see Convention with the Netherlands Respecting Double Taxation and Taxes on Income, April 29, 1948, art. VIII, 62 Stat. 1757 (1948), T.I.A.S. No. 1885. Subsequent modifications, amendments and extensions of this convention are listed in Kingson, *Investments*, at 46 n.192.

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terest rates would have to be increased to yield a net rate sufficiently attractive to be competitive. If interest on all bonds had to be grossed up, however, convertibles would still cost the borrower less than straights. In addition, popular convertible debentures are freely transferable, and the ensuing fluctuation in withholding rates, depending upon the nationality of the transferee and the terms of any applicable treaties, would create insurmountable administrative difficulties.[15] American companies were therefore forced to devise a mechanism which would permit them to avoid the withholding requirement on bond interest.

Contrary to what often seems to be the case, the long arm of the tax collector is limited by some extraterritorial boundaries. Nonresident aliens not doing business in the United States are not subject to United States withholding on interest payments unless such payments constitute "gross income from sources within the United States." [16] As long as interest payments can be categorized as income arising "from sources without the United States"—foreign source income—[17] withholding can be avoided.

The answer to this withholding problem is found in section 861(a)(1)(B) of the Internal Revenue Code, which provides that interest on bonds, notes and other interest-bearing obligations of a domestic corporation is deemed to arise outside the United States if paid by a corporation which derives from sources within the United States less than 20 percent of its total gross income.[18] Since the vast majority of United

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[15] For example, the sale of a given debenture by a resident of one country to a resident of another not only would necessitate a change in the borrowing company's list of creditors, but also, and more importantly, could require a change in the percentage of the interest payments withheld as United States income tax. The administrative burden of making such changes each time a debenture is transferred would increase in proportion to the extent of trading in a company's convertible debentures.

[16] The quoted language is used in Int. Rev. Code of 1954, §§ 871(a)(1) (imposing a 30% tax on alien individuals receiving such income); 881(a) (imposing same tax on foreign corporations); 1441(a) (providing for the withholding of the tax imposed by § 871); 1442(a) (adopting by reference the quoted language in § 1441). Moreover, Int. Rev. Code of 1954, §§ 871(b), 882 provide that if a nouresident alien individual or a foreign corporation is "engaged in trade or business within the United States," any income received which is "effectively connected" with that business will be taxed at the regular tax rates as set forth in §§ 1, 1201. For purposes of this Article, it is assumed that the owner of any Eurobond does not engage in a trade or business within the United States, or, if the owner is so engaged, that the interest on the bond is not "effectively connected" with such business.

[17] For a specific enumeration of the items of gross income which "shall be treated as income from sources without the United States," see Int. Rev. Code of 1954, § 862(a).

[18] *Id.* § 861(a) provides in part:

(a) Gross Income From Sources Within United States.—The following items

States companies could not meet this test, it became necessary for corporations wishing to market convertible debentures to enter an administrative labyrinth of exceedingly complex dimensions. The first step in the pattern is the creation of a domestic corporation which disdains domestic business in order to operate as a finance subsidiary for foreign operations.[19] Since the primary source of the subsidiary's income would be interest and dividends earned on loans to and investment in foreign affiliates, the company can easily meet the percentage requirements of section 861 (a) (1) (B).

Having no substantial business of its own, however, the finance subsidiary would have no credit standing, and all its borrowings would have to be unconditionally guaranteed by the parent company. Similarly, the stock of the finance company would hold no investment interest and any convertible debentures that it issued would have to be convertible into the stock of its publicly-owned parent.

The initial problem encountered in establishing a finance subsidiary is the Internal Revenue Service's ability to challenge the separate existence of the company. An inadequately capitalized subsidiary issuing debentures which are guaranteed by the parent, convertible into the stock of the parent, and which are sold to the foreign public in order to invest the proceeds in the parent's foreign subsidiaries, would be ripe for attack as a sham corporation[20] or for reallocation of income

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of gross income shall be treated as income from sources within the United States:

> (1) INTEREST.—Interest from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including—
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> (B) interest received from a resident alien individual or a domestic corporation, when it is shown to the satisfaction of the Secretary or his delegate that less than 20 percent of the gross income from all sources of such individual or such corporation has been derived from sources within the United States, as determined under the provisions of this part, for the 3-year period ending with the close of the taxable year of such individual or such corporation preceding the payment of such interest, or for such part of such period as may be applicable.

[19] Although it would not be imperative for the domestic subsidiary to eschew all United States business, it would be wise for it to do so. Since the 80-20 ratio of foreign to domestic source income must be maintained in each tax year, a domestic company, whose income from domestic sources unexpectedly exceeded the permissible 20% in a given year, could lose its exemption from the withholding provisions even though it normally derived much less income from domestic sources. INT. REV. CODE of 1954, §§ 861, 1441-42.

[20] In such a situation the Internal Revenue Service, following Murphy Logging Co. v. United States, 239 F. Supp. 794 (D. Ore. 1965), *rev'd*, 378 F.2d 222 (9th Cir. 1967),

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and expenses to the parent company under section 482 of the Code.[21] In either event, the parent would lose the benefit of section 861(a)(1)(B). Fortunately, however, the Administration's policy has been to encourage foreign borrowing to finance foreign investment,[22] and the Service facilitated this approach by adopting an unwritten rule that a finance company which always maintained a debt-to-equity ratio not in excess of five-to-one would be recognized as a separate taxpayer, not vulnerable to reallocation of income or expenses.[23] Although a private ruling is not a prerequisite to favorable treatment, provided these guidelines are followed, a prudent taxpayer would be wise to obtain such a ruling despite partial formal recognition of the five-to-one requirement.[24]

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could assert that the borrowing had actually been undertaken by the parent-guarantor, and interest paid would be deemed to have been paid by the parent subject to the withholding provisions of INT. REV. CODE of 1954, §§ 1441-42, since the parent would not come within the § 861(a)(1)(B) exemption. See note 18 *supra* and accompanying text. For a discussion of *Murphy Logging,* including a criticism of the Ninth Circuit's reversal, see Kingson, *Investment,* at 34 & nn.135-36.

21 In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

INT. REV. CODE of 1954, § 482.

22 Statement by the President Outlining a Program of Action, January 1, 1968, *quoted in Hearings on the Administration's Balance-of-Payments Proposals Before the House Comm. on Ways and Means,* 90th Cong., 2d Sess., pt. 1, at 51-60 (1968); Lancaster, *FDIR,* at 93.

23 *See* Kingson, *Investment,* at 33, 37. See note 24 *infra.*

24 Rev. Rul. 69-377, 1969 INT. REV. BULL. No. 27, at 30, describes the formation of a domestic finance subsidiary, the contribution to the capital of this subsidiary by the parent company of "5,000 x dollars," and the subsequent sale of "25,000 x dollars" of debt obligations by the subsidiary. *Id.* at 28. Where the five-to-one ration is maintained, the Treasury Department seems to have found that debt obligations "have all the indicia of bona fide indebtedness." *Id.* at 29. It is not wholly clear what debt is covered by the five-to-one requirement, but it is probably safe to say that only debts of the finance company incurred to finance foreign operations are included. This is an easily ascertainable figure and one which is not subject to daily fluctuation. If the finance subsidiary incurs debt in the form of rent or salaries, etc., it shonld be disregarded as de minimis. The purpose of the five-to-one guideline is to permit companies to comply with the mandatory balance of payments restrictions without crippling their foreign investment programs. It would be foolish for the Internal Revenue Service to establish a rule that could, because of a § 482 reallocation, result in accidental disqualification, especially where any miscellaneous debts which might be incurred by the finance company are minuscule in relation to the minimum size of a debenture offering which is necessary to make the whole enterprise worthwhile.

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Capitalizing the Subsidiary

The solution of the withholding problem leads to another difficulty. Given the need for equity capital at least equal to one-fifth of the face amount of the convertible debenture offering, the parent company must determine the nature of the capital to be contributed. Regardless of the ultimate decision, of course, the transfer itself will not result in taxable income to the parent.[25]

One popular method of supplying the needed equity capital has been of the "bootstrap" variety. Assume that the finance company plans a 20 million dollar issue of convertible debentures. To supply the necessary equity, the parent company negotiates a 4 million dollar bank loan and contributes the proceeds to the finance company. The finance company, in turn, immediately deposits the money in an account at the lending bank. The parent typically pays an interest rate a fraction of a percent higher than the rate which the bank pays the finance company; the differential serves as the bank's fee for facilitating the transaction. Normally the bank involved would be a foreign branch of a domestic bank, as this permits the interest earned by the finance company to be foreign source income for purposes of section 861(a)(1)(B)[26] while the parent need not withhold on the interest payments.[27]

This financial arrangement was originally recognized as valid by the Internal Revenue Service only if the deposit by the finance company did not serve as collateral for the loan to the parent. If the finance company's right to the return of its deposit was conditioned upon prior payment of the loan or substitution of collateral by the parent, the value of the deposit to the finance company was held to be less

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25 INT. REV. CODE of 1954, § 351(a) provides in part:

> No gain or loss shall be recognized if property is transferred to a corporation . . . by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation.

26 Under the FDIR a "foreign bank" includes "any branch or office within a foreign country of . . . [a bank or trust company organized under the banking laws of the United States]." 15 C.F.R. § 1000.317(b) (1969).

27 See note 12 *supra* and accompanying text. The deposit of funds abroad outside of Canada by a domestic company is severely limited by 15 C.F.R. § 1000.203 (1969), and a deposit for less than one year requires the prior approval from the Office of Foreign Direct Investments (O.F.D.I.) if the company's general authority were to be exceeded. In light of the nature of the deposit, such a ruling will normally be issued by O.F.D.I. If the deposit is for a period greater than one year, or is made in Canada, § 1000.203 does not apply and no O.F.D.I. ruling is needed. Notwithstanding the length of the obligation, no Interest Equalization Tax is payable when funds are deposited with the foreign branch of a United States bank.

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than 4 million dollars and the five-to-one ratio was exceeded. If the transaction was arranged in such a manner that the bank could call in the loan to the parent when the subsidiary withdrew its deposit, the value of the deposit was not impaired and the initial five-to-one ratio was retained. It is understood that the Internal Revenue Service is reviewing the collateral problem with a view to possible relaxation of the existing policies. Taxpayers should explore this area with the Service and any company using the bootstrap method of capitalization would be wise to obtain a ruling covering this point.

An alternative method for capitalizing finance subsidiaries is the contribution of stock of one or more of the parent's foreign subsidiaries. Stock of domestic subsidiaries is avoided because dividends will then be United States source income. The contribution of stock naturally raises valuation problems and the parent company must be sure it is continually within the five-to-one limit. A simple cash contribution is also possible, but this method of capitalization has not had the popularity of the bootstrap method because it uses up liquid reserves. Regardless of the method used, however, the Service will not recognize the finance subsidiary as a separate taxpayer if it lends its capital back to the parent company.

Foreign Tax Credits

Regardless of its capitalization, the finance subsidiary will be in business to lend money to, and invest equity capital in, foreign enterprises. Interest and dividend payments from these enterprises will result in the withholding of foreign income taxes, and the domestic finance company must have sufficient taxable income to enable it to take advantage of its foreign tax credits, both direct and "deemed paid." [28]

Prior to investment of its debenture proceeds, the finance company may, for business reasons, deposit its funds in a foreign bank. Unfortunately, the interest income from such deposits is vulnerable to

[28] INT. REV. CODE of 1954, § 901(b)(1) allows the domestic finance subsidiary a credit against its United States income taxes in the amount of "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." Section 902 makes available additional tax credits resulting from the payment of foreign taxes by certain foreign subsidiaries. Section 904 places certain limitations on the amount of foreign tax credits that can be taken in any single taxable year. The taxpayer may elect one of two alternative limitations provided in § 904(a), and § 904(d) provides for limited carrybacks and carryovers of credits not available for use in prior years.

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separate tax credit treatment.[29] If the Service separates short-term interest from investment income derived from affiliates, the company may be unable to make optimal use of its tax credits.[30] The Service's power to require separate computations was introduced into the Code in 1962 to stop the practice of depositing short-term funds in Canada to use up excess foreign tax credits arising from operating income.[31]

To avoid separate computations of the foreign tax credit, the taxpayer would have to argue either that the interest earned abroad on bank deposits pending investment in affiliated companies was "derived in the conduct of [its] . . . financing . . . business" or that it was "derived from any transaction which is directly related to the active conduct" of its business.[32] The latter alternative would be most persuasive since, while the making of the deposit itself is not a financing activity, it is clearly incident to such activity. The deposit should ouly be held for a reasonably short period of time and the taxpayer must be able to demonstrate that the deposited funds relate to the financing of investments contemplated in the near future. The Service should recognize that the funds were deposited abroad solely because of Government controls and make a favorable determination in appropriate cases.

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[29] *Id.* § 904(f) (1), (2), provide in part:

(f) Application of Section in Case of Certain Interest Income.—

(1) In General.—The provisions of subsections (a), (c), (d), and (e) of this section shall be applied separately with respect to—

(A) the interest income described in paragraph (2), and

(B) income other than the interest income described in paragraph (2).

(2) Interest Income to Which Applicable.—For purposes of this subsection, the interest income described in this paragraph is interest other than interest—

(A) derived from any transaction which is directly related to the active conduct of a trade or business in a foreign country or a possession of the United States,

(B) derived in the conduct of a banking, financing, or similar business,

(C) received from a corporation in which the taxpayer (or one or more includible corporations in an affiliated group, as defined in section 1504, of which the taxpayer is a member) owns, directly or indirectly, at least 10 percent of the voting stock,

(D) received on obligations acquired as a result of the disposition of a trade or business actively conducted by the taxpayer in a foreign country or possession of the United States or as a result of the disposition of stock or obligations of a corporation in which the taxpayer owned at least 10 percent of the voting stock.

[30] *Id.* § 904(f) (3). *See id.* § 904(a)(1), (2), which set "per country" and "overall" limitations on usable tax credits.

[31] S. Rep. No. 1881, 87th Cong., 2d Sess. 72-74 (1962). At the time of the enactment, the Canadian income tax rate on interest was only 15%, while the Canadian rate on business income was 57½%. Both classes of income were taxed at the rate of 52% in the United States.

[32] Int. Rev. Code of 1954, § 904(f) (1), (2), *quoted in* note 29 *supra*.

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If, on the other hand, the finance company operates at a loss or with insufficient income to use a substantial part of its tax credits, the parent company will have to file a consolidated income tax return[33] to take advantage of the consolidated tax credit provisions.[34] Although this alternative will probably be available because the parent and its domestic finance subsidiary will invariably constitute an affiliated group,[35] the parent will have to weigh carefully the tax consequences of a consolidated return.

Conversion Problems

Once a finance subsidiary is successfully created and operating in compliance with the limitations of section 861(a)(1)(B), there remains a further tax problem: the conversion of convertible debentures. Probably the least desirable method of conversion is for the parent to contribute its stock to the finance company, allowing it to make the conversion. If the parent contributed authorized but unissued stock, as would most likely be the case, it would have a zero basis in the hands of the finance company;[36] if the parent contributed treasury stock, it would have a basis equal to the price at which the parent had acquired the stock.[37] In either event, conversion could produce a sizeable gain equal to the difference between the basis of the stock delivered and the face value of the debenture converted.[38] While the finance company might attempt to claim a deduction in the amount of the difference between the value of the stock issued and the face value of the indebtedness on the ground that it is in the nature of a bond premium payment, it would almost certainly be unsuccessful.[39] Al-

33 *Id.* §§ 1501-04.

34 *See* Treas. Reg. § 1.1502-4 (1966).

35 INT. REV. CODE of 1954, § 1504 (parent and subsidiary will qualify as an affiliated group if the parent owns "at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock" of the subsidiary).

36 *Id.* § 362 provides that property acquired by a corporation as a contribution to capital shall have the same basis as "in the hands of the transferor, increased in the amount of gain recognized to the transferor." Since no gain is recognized on the parent's contribution to the capital of the finance subsidiary, the subsidiary assumes the parent's basis under § 351(a).

37 *Id.*

38 Since the stock exchanged by the finance company for the debentures would be the stock of its parent and not its own stock, the nonrecognition provisions of § 1032 would be inapplicable.

39 Prior to December 24, 1968, Treas. Reg. § 1.61-12(c)(3) provided:

> If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the

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ternatively, the finance company could purchase stock from its parent at fair market value, following which the parent could forgive the debt as a contribution to capital.[40] Or the parent might transfer funds to the subsidiary in advance of the purchase. In either event, however, the Service would have a convincing argument that the transaction amounted to a contribution of the parent's stock subject to the carryover basis rules.[41] Moreover, the question of a deduction for the finance subsidiary would remain unresolved.

A better plan would be for the parent to issue its stock in exchange for the debentures so that the finance subsidiary would be indebted to the parent. The issuance of the parent's stock by it would be a tax-free transaction[42] and the debt could be cancelled as a contribution to capital. There is certainly a risk that the Service might view the transaction as a constructive contribution of stock by the parent to the finance subsidiary and therefore a taxable exchange by the latter, but the transaction is certainly less likely to be accorded such treatment than those discussed above. Furthermore, the Service will probably curb efforts at extracting tax dollars from taxpayers forced into difficult positions by balance of payments restrictions.

From a tax viewpoint, however, the most satisfactory form of conversion would be for the finance subsidiary to purchase its parent's

> purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year.

This language was eliminated by T.D. 6984, 1969 INT. REV. BULL. No. 6, at 7, and was replaced by Treas. Reg. § 1.163-3(c)(2) (1969), which provides in part:

> In the case of a convertible bond (except a bond which the corporation, before Sept. 5, 1968, has obligated itself to repurchase at a specified price), the deduction allowable under subparagraph (1) of this paragraph may not exceed an amount equal to one year's interest at the rate specified in the bond, except to the extent that the corporation can demonstrate to the satisfaction of the Commissioner or his delegate that an amount in excess of one year's interest does not include any amount attributable to the conversion feature.

A similar provision was enacted by Congress as § 414 of the Tax Reform Act of 1969, INT. REV. CODE of 1954, § 249. *See also* Roberts & Porter, Inc., 37 T.C. 23 (1961), *rev'd*, 307 F.2d 745 (7th Cir. 1962). The Tax Court denied a deduction for the excess of the purchase price of debentures over the call price. The Court of Appeals reversed, holding that this excess represented a necessary business expense deductible under INT. REV. CODE of 1954, § 162. However, the Service has refused to consider the decision in *Roberts* to be dispositive in similar cases. Rev. Rul. 67-409, 1967-2 CUM. BULL. 62.

40 Treas. Reg. § 1.61-12(a) (1963).

41 See note 36 *supra*.

42 "No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation." INT. REV. CODE of 1954, § 1032(a).

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stock on the open market at the time of redemption. In this manner a deduction for the cost of such stock in excess of the face value of the debt could be obtained. Although the parent would have to make a sizeable cash outlay, this cost could be preferable to dilution of stockholder equity. Alternatively, the parent could purchase the stock in the open market as debentures are converted and transfer it to the finance company as a contribution to capital.

Tax Consequences to Foreign Bond-Holders

In marketing convertible debentures, the tax consequences to the purchasers are also significant. As mentioned above,[43] avoidance of United States withholding tax is essential. Freedom from withholding is so important that a prospectus normally provides not only an opinion that no withholding is required but also a guarantee that if withholding should be required, the debtor will pay the debenture holder an additional amount sufficient to produce the net interest rate stated in the prospectus. The purchaser will not, however, be entitled to exemption from withholding on dividends after conversion of his debenture, unless a treaty provides otherwise.

The debenture holder is also concerned about the tax consequences of sale, redemption or conversion. While the conversion of a debenture into stock would not normally produce taxable income,[44] the conversion of one company's debenture into the stock of a second company would ordinarily be a taxable transaction.[45] Fortunately, as long as the debenture holder is a nonresident alien not doing business in the United States and, if an individual, is not present in the United States for more than 182 days during the taxable year, the gain from the sale, exchange, redemption or conversion of the debenture will be exempt from federal taxation.[46]

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43 See text at notes 14-15 *supra.*

44 I.T. 2347, VI-1 Cum. Bull. 86, 87 (1927):

> No gain or loss is recognized where the bondholder exercises the right to convert the bond into stock of the issuing corporation. The basis for computing gain or loss upon subsequent sale of the stock would be the basis of the bond exchanged therefor.

45 Rev. Rul. 69-135, 1969 Int. Rev. Bull. No. 12, at 17:

> [G]ain or loss is recognized on the exchange of the bonds of *X* for common stock of *Y* to the extent of the difference between the fair market value of the common stock of *Y* received and the cost or other basis of the bonds of *X* exchanged therefor.

46 Int. Rev. Code of 1954, § 871(a)(1)(C), (a)(2). Notwithstanding this exemption from taxation, taxpayers normally seek a ruling from the Service to the effect that

An individual acquiring a debenture also will be concerned about the possibility of United States estate taxes if he should die while owning the debenture. Tax laws also exempt a nonresident alien's debenture holdings from federal estate tax.[47] Because of the intricacies of the law, however, if the purchaser of the debenture has converted it to stock prior to his death, his stock holdings will be subject to federal estate tax.[48]

Foreign Finance Companies

The preceding discussion has been intentionally limited to domestic finance subsidiaries because foreign finance companies, while occasionally employed, offer no tax advantages.[49] The primary advantage of the foreign subsidiary is its ability to lend to its United States parent, thus enabling the parent to refinance short-term foreign indebtedness without running afoul of the Foreign Direct Investment Regulations. A domestic finance company cannot fulfill this function without danger of exceeding the 20 percent limitation on United States source income, because even if the domestic company lent funds interest free, the Commissioner would made a statutory allocation of interest at the rate of five percent.[50] Depending upon the facts involved, a taxpayer using a foreign finance company could secure rulings from the Service with respect to the absence of tax avoidance motives.

Securities Aspects of Foreign Borrowing

Investment Company Act

A domestic finance company will have to borrow large amounts and will invest in various securities, including short- or medium-term paper, pending ultimate investment in its parent's foreign affiliates. Thus, the subsidiary resembles a closed-end investment company, and its status

conversion or redemption does not produce "fixed or determinable annual or periodical" income and that no withholding is required under §§ 1441-42.

[47] *Id.* §§ 2106 (inclusion of all property situated within the United States in the taxable estate of a nonresident decedent), 2104(c) (excluding from "property within the United States" all debt obligations of a United States corporation if the interest thereon would be treated as income from sources without the United States under § 861(a)(1)(B).

[48] *Id.* § 2104(a).

[49] For a discussion of the income tax disadvantages of foreign finance corporations, see Kingson, *Investment,* at 43-45.

[50] Treas. Reg. § 1.482-2(a)(2)(*ii*) (1968).

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under the Investment Company Act of 1940 is not clear.[51] If the company were subject to the statute, it would be required to register,[52] a burdensome process primarily designed for mutual funds. Furthermore, since a finance company would, if covered by the Investment Company Act, qualify as a closed-end investment company,[53] it would be so severely limited in its ability to issue senior debt that a convertible debenture offering would be highly impractical.[54] Therefore, after developing the use of a domestic finance subsidiary to facilitate the tax planning of overseas financing, it next becomes essential to secure an exemption from the Investment Company Act.

Fortunately, the Securities and Exchange Commission possesses the power to grant exemptions when "necessary or appropriate in the public interest and consistent with the protection of investors." [55] The Commission had developed an internal policy for granting favorable orders upon application, but because of the sizeable number of finance companies created in response to the President's voluntary balance of payments cooperation program, in 1967 the Commission eliminated the need for individual rulings by issuing a specific exemption for subsidiaries organized to finance the foreign operations of domestic

[51] Section 3(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-3(a) (1964), defines an investment company as

> any issuer which—
>
> (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
>
> (2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
>
> (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

[52] *Id.* § 80a-7.

[53] A closed-end company is defined as "any management company other than an open-end company." An "open-end company" is "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer." *Id.* §§ 80a-5(a)(1), (2) (1964). Since a domestic finance subsidiary issues and has outstanding debentures which are convertible into the stock of another company (the parent), it is arguably a closed-end company.

[54] *Id.* § 80a-18(a)(1). Under this section it is unlawful for a closed-end investment company to issue any class of senior security representing indebtedness unless it will have an asset coverage of 300% after the issuance. Moreover, such a company must maintain 300% asset coverage in order to pay dividends on common stock, and have at least 200% asset coverage to pay dividends on preferred stock. Furthermore, certain provisions must be made for senior security holders to elect a majority of the board of directors if asset coverage falls below 100%.

[55] *Id.* § 80a-6(c).

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companies.[56] The rule granting the exemption defines a "finance subsidiary" as a wholly-owned domestic subsidiary of an operating company, "the primary purpose of which is to finance the foreign business operations of the parent company through the sale of the finance subsidiary's securities, including borrowings, outside the United States, and the organization of which is consistent with the President's program to improve the balance of payments position of the United States." [57] Thus, in the same manner as the Internal Revenue Service, the SEC devised certain rules to permit continued foreign investment in a manner consistent with United States balance of payments objectives.

A company qualifying under the SEC's definition of a finance subsidiary is automatically exempt from the Investment Company Act if it meets eight separate conditions,[58] the first of which is that "the parent company is the issuer of a class of securities which have been registered under section 12 of the Securities Exchange Act of 1934 or exempted from such registration pursuant to Rule 12g3-2(b) under that Act." [59] This condition precludes exemption of closely held companies, thus insuring that debenture holders will have the benefit of the reporting and disclosure requirements of the Securities Exchange Act. While finance subsidiaries of closely held companies would not issue debt convertible into their parent's stock in any event, the rule also precludes closely held companies from using a finance subsidiary to issue straight debt or to issue debentures convertible into the stock of an unrelated company. In the latter case, however, if the closely held parent had in escrow the stock of another company into which the debentures were convertible and if the issuing company of such stock were registered under the Exchange Act, a good case could be made in applying for a special exemption.

The next three conditions do not present any particular problems in conducting a domestic subsidiary finance operation.

> (2) debt securities of the finance subsidiary isssued to or held by the public are guaranteed by the parent company as to payment of

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[56] On December 7, 1967, the SEC issued a notice of proposed rule-making to exempt such subsidiaries from the Investment Company Act. 32 Fed. Reg. 17861 (1967). A somewhat modified final version was adopted in March of 1968, after the imposition of the FDIR, and now appears as SEC rule 6c-1, 17 C.F.R. § 270.6c-1 (1969).

[57] *Id.* § 270.6c-1(a)(1), (2).

[58] *Id.* § 270.6c-1(b)(1)-(8).

[59] *Id.* § 270.6c-1(b)(1).

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principal, interest and premium, if any, provided that the securities issued by the finance subsidiary may be subordinated in right of payment to other debt of the parent company;

(3) any preferred stock of the finance subsidiary issued to or held by the public is unconditionally guaranteed by the parent company as to payment of dividends, payment of the liquidation preference in the event of liquidation, and payments to be made under a sinking fund, if a sinking fund is provided;

(4) any public offering of the securities of the finance subsidiary is made pursuant to underwriting or distribution agreements, the terms of which prohibit the offer or sale thereunder of such securities to nationals or residents of the United States or its territories or possessions;[60]

The parent's guarantee is a practical necessity in order for the finance subsidiary to market any of its securities. Condition (4) merely dovetails with the Foreign Direct Investment Regulations to insure that balance of payments objectives are not easily subverted. Borrowing in the United States to finance foreign investment is as harmful as direct investment without borrowing. The negative tone of the condition, however, conceals the fact that it authorizes United States persons to participate in a group that underwrites the finance company's convertible debentures or other securities.[61] Moreover, the restriction only applies to the original vendor and in no way prevents the first purchaser who is not in the underwriting group from selling his debenture or converted stock in the United States. The likelihood of a quick sale to a United States taxpayer is reduced, however, by condition (5):

(5) any securities of the finance subsidiary which are convertible or exchangeable shall only be convertible or exchangeable for securities of the parent company and such conversion or exchange shall not take place prior to six months from the date of issuance or such shorter period of time as the Secretary of the Treasury or his delegate may approve in writing to the finance subsidiary or the parent company;[62]

By postponing conversion for six months, condition (5) prevents or at least substantially diminishes the possibility that the debt obligation

[60] *Id.* § 270.6c-1(b)(2)-(4).

[61] Investment Company Act Release No. 5330, 33 Fed. Reg. 5294 (1968). Underwriters are also specifically exempted from the Interest Equalization Tax by INT. REV. CODE of 1954, § 4919(a). See note 63 *infra*.

[62] SEC rule 6c-1, 17 C.F.R. § 270.6c-1(b)(5) (1969).

represented by the convertible debentures will be rapidly repatriated to the United States because purchase of the unconverted debentures would be subject to the Interest Equalization Tax.[63] The six-month provision was a compromise accepted by the SEC to prevent adverse balance of payments consequences for some minimum period without substantially impairing the value of the convertible debentures.

Condition (6) is designed to insure that the finance subsidiary fulfills its avowed purpose of financing investment abroad, but the language is sufficiently flexible to allow the company ample time to complete its program.[64]

> (6) upon completion of the long-term investment program of the finance subsidiary, at least 80 per cent of its assets, exclusive of United States Government securities and cash items, will consist of investments in or loans to foreign companies (or domestic companies, substantially all the business of which is conducted outside the United States);[65]

Condition (7) requires that most of the subsidiary's investment be made in companies with which its parent has a strong business relationship, thereby insuring that the finance subsidiary does not become a disguised mutual fund.[66]

> (7) at least 90 per cent of the assets of the finance subsidiary, exclusive of U. S. Government securities and cash items and short-term investments in foreign government and commercial paper, will

[63] INT. REV. CODE of 1954, § 4911 (a) imposes a tax on "each acquisition by a United States person . . . of stock of a foreign issuer, or of a debt obligation of a foreign obligor . . . ." *See id.* §§ 4912 (definition of "acquisition" and special rules), 4913-18 (setting forth specific exclusions from the tax). Exemption from the Investment Company Act depends upon compliance with a provision in SEC rule 6c-1 which requires that securities purchased by nationals or residents of the United States when issued by the finance subsidiary be subjected to the Interest Equalization Tax. 17 C.F.R. § 270.6c-1 (c) (1) (1969). See text at note 73 *infra*.

[64] For a brief discussion of minor problems caused by condition (6), see Kingson, *Investment*, at 35.

[65] 17 C.F.R. § 270.6c-1 (b) (6) (1969).

[66] Except for the restrictions contained in SEC rule 6c-1, a domestic finance subsidiary might well dabble in foreign mutual fund operations. Under the rule domestic finance subsidiaries differ from mutual funds in that they (1) sell debentures only to a restricted market—nonresidents and noncitizens of the United States outside of the United States, (2) can only invest in certain enterprises, namely those affiliated with their parent, and (3) even when handling permitted investments cannot "deal or trade" —thus purchases must be for bona fide investment.

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> be invested in or loaned to companies at least 10 per cent of the equity securities of which are, or at the completion of the investment will be owned, directly or indirectly, by the parent company, and any assets of the finance subsidiary not invested in such companies will only be invested in or loaned to companies which are customers or suppliers of the parent company or a subsidiary of the parent company; and any of the assets invested in or loaned to investment companies will only be invested in or loaned to investment companies which are wholly-owned subsidiaries of the parent company;[67]

While the SEC recognized that finance companies frequently have to invest their borrowed proceeds in unrelated activities pending the future needs of foreign affiliates, the Commission limited such "waiting period" investments to United States Government securities, foreign governmental and commercial paper with a maturity not exceeding nine months,[68] and to cash items. Cash items are not defined, but the Commission would regard a 13-month certificate of deposit as a cash item.[69] Such an interpretation is critical because it permits finance subsidiaries to make relatively short-term investments pending ultimate investment without violating the Foreign Direct Investment Regulations restriction on liquid foreign balances.[70] If the funds had to be returned to the United States pending ultimate disposition, the subsidiary's income source ratio might be changed sufficiently to disqualify it from favorable treatment under section 861(a)(1)(B) of the Internal Revenue Code.[71]

Like condition (7), condition (8), which provides that "the finance subsidiary will not deal or trade in securities,"[72] prevents a finance company from acting like an investment company even though it can

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67 *Id.* § 270.6c-1(b) (7).

68 The Investment Company Act defines "short-term paper" as "any note, draft, bill of exchange, or banker's acceptance payable on demand or having a maturity at the time of issuance of not exceeding nine months." 15 U.S.C. § 80a-2(a)(36) (1964).

69 Although there is no published SEC interpretation to this effect, the author understands from informal discussion with staff members, that the Commission Staff has taken this position.

70 15 C.F.R. § 1000.203(c) (1969) restricts the amount of liquid assets a direct investor may maintain in foreign countries. However, specifically exempted from the definition of "liquid foreign balances" are "bank deposits, negotiable instruments, non-negotiable instruments, commercial paper and securities with a period of more than 1 year remaining to maturity when acquired by the direct investor and which are not redeemable in full at the option of the direct investor within a period of 1 year after such acquisition." *Id.* § 1000.203(a)(2)(*ii*).

71 See notes 18, 19 *supra* and accompanying text.

72 17 C.F.R. § 270.6c-1(b)(8) (1969).

trade only in the securities of the parent's foreign customers or in blocks of stock which exceed 10 percent of a foreign company's equity. Moreover, rule 6c-1 contains two additional requirements for an exemption from the Investment Company Act. First, at the time of issuance, the subsidiary's convertible debentures or other securities must be subject to the Interest Equalization Tax if acquired by a United States national or resident.[73] Second, the finance company must cease issuing securities without an order from the Commission if the Interest Equalization Tax expires or is repealed.[74]

Under the Interest Equalization Tax, acquisition of stock or obligations of a domestic corporation by a United States citizen or resident will be taxed if the domestic corporation is "formed or availed of for the principal purpose of obtaining funds (directly or indirectly) for a foreign issuer or obligor," [75] and the acquisition of the foreign issuer's or obligor's securities would also be taxed. Since the function of the typical finance subsidiary is to provide funds for the parent's foreign affiliates, it is formed for the requisite purpose. Where the parent's foreign affiliates operate in underdeveloped areas, however, they may qualify as "less developed country corporations." [76] Since a direct acquisition of the securities of such corporations would be exempt from the Interest Equalization Tax,[77] acquisition of the stock of a domestic

[73] See note 63 *supra*. It should be noted that acquisition by a United States citizen or resident of the stock of the finance company's parent would not give rise to the Interest Equalization Tax. While it could be argued that the domestic parent was being availed of in this instance for the principal purpose of obtaining funds for a foreign issuer, the Internal Revenue Service has chosen to interpret INT. REV. CODE of 1954, § 4912(b)(3), with a view to the company's entire activities and not with a view to a particular transaction. Clearly, from this perspective, the parent company, normally a large manufacturing enterprise, does not meet the "formed or availed of" test. See text at note 75 *infra*.

[74] Rule 6c-1, 17 C.F.R. § 270.6c-1(c) (1969).

[75] INT. REV. CODE of 1954, § 4912(b)(3).

[76] *Id.* § 4916(c). In order for a country to be a "less developed country" there must be an effective Executive Order so designating the country. Additionally, such a "less developed country corporation" must satisfy certain ownership, income and asset requirements. *Id.* Schedule A countries are coextensive with countries desiguated as less developed for purposes of § 4916. 15 C.F.R. § 1000.319(a) (1969).

There is also an exemption for direct investments, INT. REV. CODE of 1954, § 4915(a), but this applies only to obligations of foreign companies in which the creditor or an affiliate of the creditor has at least a 10% interest. While this provision would exempt the parent company from the Interest Equalization Tax, Rev. Rul. 69-377, 1969 INT. REV. BULL. No. 27, at 27, if it acquired the debentures of its finance subsidiary, it would not exempt any other United States citizen or resident from the tax and the Investment Company Act exemption would not be lost.

[77] INT. REV. CODE of 1954, § 4916(a)(2).

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corporation "formed or availed of" for the principal purpose of financing such corporations would also be exempt from the tax. As a consequence, the Investment Company Act exemption would be lost. The loss of the exemption can be avoided, however, by interposing between the parent's finance subsidiary and the less developed country affiliates another foreign company which is not entitled to an Interest Equalization Tax exemption. While the intermediary company conceivably could be disregarded, the Internal Revenue Service is unlikely to hinder Administration policy[78] by making compliance with foreign investment and securities guidelines impossible, and although the SEC does not require it, the Service will issue a so-called "adverse" Interest Equalization Tax where the taxpayer has complied with all technicalities.[79] Generally, taxpayers rely on opinions of counsel, but if the problem of less developed country corporations is present, it would be prudent to secure a formal ruling.

Securities Act of 1933

Since the marketing of debentures by a finance subsidiary normally would involve a public offering, the restrictions of the Securities Act of 1933[80] appear to require registration. The SEC has, however, adopted the policy of not applying the Securities Act to transactions outside the United States if the purchasers are not likely to be United States citizens or residents.[81] Since the Investment Company Act exemption requires that the debentures not be offered to United States citizens or residents and because the Interest Equalization Tax would apply to the acquisition of the debenture by a United States citizen or resident, it is highly unlikely that the domestic finance subsidiary's public debenture offering would involve distribution in the United States. Accordingly, the SEC will issue "no action" letters under the 1933 Act with respect

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[78] *See* Statement of President Nixon, 5 WEEKLY PRES. DOC. 510 (1969):

> I have approved a recommendation to relax somewhat the foreign direct investment program of the Department of Commerce. This means that most firms investing abroad will have substantially more freedom in planning these investments.

[79] The transfer of funds from a domestic finance company to a foreign affiliate in a developed country and then to a less developed country corporation will result in certain complications under the FDIR. See notes 97-110 *infra* and accompanying text.

[80] 15 U.S.C. § 77e (1964). Compliance with rule 6c-1 only exempts the foreign finance subsidiary from the operation of the Investment Company Act.

[81] *See generally* Goldman & Magrino, *Some Foreign Aspects of Securities Regulation: Towards a Reevaluation of Section* 30(*b*) *of the Securities Exchange Act of* 1933, 55 VA. L. REV. 1015 (1969).

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to the sale of debentures abroad.[82] Although the debentures need not be registered under the Securities Act, companies have traditionally registered them on the New York Stock Exchange and on at least one foreign exchange to provide ready transferability.

While convertible debentures are exempt from registration, the stock into which the debentures are to be converted is not. Once the debenture is converted, the Interest Equalization Tax is inapplicable to the stock[83] and there are no restrictions on sale in the United States. Consequently, there exists sufficient likelihood that the stock will be sold in the United States to require registration under the 1933 Act.[84] In addition, the prospectus must be periodically updated,[85] because con-

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[82] *See* Kingson, *Investment*, at 34. Of course, acquiring such a letter is not a prerequisite to favorable treatment by the Commission and if time does not permit obtaining such a letter, it would not be imprudent to proceed without it. In Investment Company Act Release No. 5186, 32 Fed. Reg. 17861 (1967), the SEC stated that

> [i]f the proposed rule is adopted, the Commission anticipates that any finance subsidiary which would qualify for exemption under Rule 6c-1 need not be concerned as to the applicability of the Securities Act of 1933 or the Trust Indenture Act of 1939 to any offering of its debt securities under limitations proscribed in the rule. It would not be necessary to register under the Securities Act of 1933 the securities of any company which would qualify for the Rule 6c-1 exemption or to qualify an indenture therefor under the Trust Indenture Act of 1939.

Id. at 17862. Subsequently, the Commission retreated from this position in Investment Company Act Release No. 5330, 33 Fed. Reg. 5294 (1968), in which it took the position that

> [t]he Commission will continue to consider on an individual basis the applicability of the Securities Act of 1933 and the Trust Indenture Act of 1939 to the securities of finance subsidiaries which qualify for the exemption from the Investment Company Act provided by Rule 6c-1.

Id. The same considerations apply with respect to the Trust Indenture Act, 15 U.S.C. §§ 77aaa-bbbb (1964). When a domestic debenture offering is made, the issuer normally establishes an indenture denominating a commercial bank as indenture trustee and which is subject to the provisions of the Trust Indenture Act. When a domestic finance subsidiary qualifies under SEC rule 6c-1, it is probably also exempted from the requirements of the Trust Indenture Act. *See* SEC Investment Company Act Release No. 5186, 32 Fed. Reg. 17861 (1967).

[83] See note 73 *supra*.

[84] The SEC sought to guard against this possibility:

> It would not be necessary to register under the Securities Act of 1933 the securities of any company which would qualify for the Rule 6c-1 exemption. . . . However, registration of the securities into which the subject securities are convertible would be subject to the registration requirements of the Securities Act of 1933. . . .

Investment Company Act Release No. 5186, 32 Fed. Reg. 17862 (1967).

[85] 15 U.S.C. § 77j(a)(3) (1964), provides in part that

> when a prospectus is used more than nine months after the effective date of the registration statement, the information contained therein shall be as of a date not more than sixteen months prior to such use, so far as such information

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version can take place at any time after the initial six months following the debenture's issuance.

FOREIGN DIRECT INVESTMENT CONSIDERATIONS

Domestic Finance Companies

Since the wide use of the domestic finance subsidiary was caused by the Foreign Direct Investment Regulations, they inject further complications into planning the lawful and profitable employment of these companies as devices for financing foreign operations. Under the Regulations, funds borrowed by the finance companies can be used to offset foreign investment[86] until such time as the debentures are redeemed or converted.[87] The finance company accomplishes the offset either by using the borrowed funds to transfer capital to foreign affiliates or by allocating funds against reinvested earnings and capital transfers not involving actual movement of funds by the finance company.[88] For example, if a direct investor with no investment allowable in Schedule C[89] acquires a new German company for 5 million dollars using the proceeds

is known to . . . or can be furnished by such user without unreasonable effort or expeuse.

86 Under 15 C.F.R. §§ 1000.306(e), 1000.313(d)(1) (1969), the direct investor is allowed to deduct the proceeds of such foreign borrowing in computing its net transfer of capital.

87 To be used to offset foreign investment, these funds must qualify as the proceeds of long-term foreign borrowing. Invariably, this requirement is satisfied. "Long-term foreign borrowing" is defined as "a borrowing by a direct investor from any foreign national . . . with an original maturity of at least 12 months from the original date of the borrowing." 15 C.F.R. § 1000.324(a) (1969). For further analysis and examples of such borrowing, see Note, *FDIP*, at 155-56.

As the debentures are redeemed in whole or part, a transfer of capital is deemed to have been made in the year of redemption to the subsidiary in which the direct investor has invested the proceeds of the initial borrowing. 15 C.F.R. § 1000.312(a)(7) (1969). A refinancing of the original borrowing by "the renewal, extension, or continuance thereof or a subsequent long-term foreign borrowing from the same or another lender" will not be considered a repayment. *Id.* § 1000.324(b)(1). However, if the direct investor exchanges equity securities for debt securities issued in the original borrowing, that exchange will be a repayment. *Id.* § 1000.324(b)(2).

88 Examples of transfers of capital not involving an actual transfer of funds are increases in open account trading balances, contributions of noncash items and leases of property for a term exceeding one year. 15 C.F.R. § 1000.312(a)(1), (2), (8) (1969). For a discussion of the leased property transfer of capital, see Note, *FDIP*, at 154-55. All domestic companies, at least 50% of which are owned directly or indirectly by a common United States parent are treated as a single person or one direct investor. 15 C.F.R. § 1000.323 (1969). Such affiliated companies are an "affiliated group." *Id.* § 1000.903.

89 *Id.* § 1000.504(a)(3).

obtained in a foreign debenture offering, there is deemed to be a zero net foreign direct investment and no violation of the Regulations.

At present the Regulations do not permit offset for investment of funds obtained from the issuance of preferred stock. On July 14, 1969, however, the Office of Foreign Direct Investments announced that specific authorizations would be issued to permit finance companies to issue convertible preferred stock "in a manner generally similar to that now accorded convertible debentures." [90] It is not at all clear how far the Office plans to pursue this policy, but, in any case, it is unlikely that finance companies would use convertible preferred except in acquiring property held by a small group of owners. A public offering of preferred with a dividend acceptable to the issuer would not be popular because of the unavailability of a general income tax withholding exemption. There would be no securities problem, however, since the Investment Company Act exemption specifically permits the use of preferred stock.[91]

Under the Regulations in effect for 1968, funds allocated against capital transfers did not have to be repatriated to the United States if they could be brought within the direct investor's liquid foreign balance limitation or if they could be converted into nonliquid foreign balances.[92] The latter conversion was accomplished by depositing the funds in a foreign bank for more than 12 months. Companies have normally preferred to keep excess funds abroad to earn the higher interest rates available in Europe[93] and also to avoid receipt of United States source interest for purposes of section 861(a)(1)(B) of the Internal Revenue Code. By using a foreign branch of a domestic bank, companies could preclude imposition of the Interest Equalization Tax. Under present Regulations, however, all foreign borrowed funds allocated to offset foreign investment must be repatriated to the United States.[94] This eliminates the ability to earn European interest on allocated proceeds of foreign borrowing and also places pressure on the 80-20 interest allocation unless United States investments are limited to certain debt obligations which produce foreign source income.[95]

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[90] Office of Foreign Direct Investments Press Release, FDI 69-9 (July 14, 1969).

[91] 17 C.F.R. § 270.6c-1(b)(3) (1968). See text at note 60 *supra.*

[92] See note 70 *supra.*

[93] In reducing the Interest Equalization Tax, Exec. Order No. 11,464 (April 3, 1969), President Nixon noted that the gap between domestic and foreign interest rates "has now narrowed." 5 WEEKLY PRES. DOC. 510 (1969).

[94] 15 C.F.R. § 1000.1003 (1969).

[95] Interest on deposits in branches of United States banks located in United States

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Foreign Finance Companies

The foregoing discussion describes how the domestic finance company fits into the scheme of the Foreign Direct Investment Regulations. Foreign finance companies also have found a place in the control system. Generally referred to as "offshore finance companies," they are used to provide long-term funds to the direct investor for the purpose of refinancing its short-term foreign borrowing while avoiding withholding on interest payments to debenture holders.

Since the finance company's debtor is a United States person, interest from the United States would exceed 20 percent and force a domestic finance company to withhold on interest payments to nonresident aliens. The foreign finance company, however, can be incorporated in a country which does not require withholding on interest payments and where the payment of interest from the direct investor to the foreign finance company, and by the foreign finance company to its bondholders, is exempted by treaty from the withholding requirements of section 1442 of the Code. Exemptions from death taxes can also be obtained. Of late, the Netherlands Antilles has proved to be a particularly attractive location which meets these requirements.[96]

While the offshore finance company can be a useful tool, its employment presents serious investment control problems. Borrowed funds do not qualify as proceeds of long-term foreign borrowing unless the debtor is a direct investor. Although a domestic finance subsidiary is treated as one and the same with the direct investor,[97] an offshore finance company is simply another affiliated foreign national. Neither funds borrowed by it nor funds borrowed from it by the direct investor qualify as proceeds of a long-term foreign borrowing.[98] Thus, a loan by an Antilles finance company to the direct investor for the purpose of repaying funds which were contributed to a Schedule C

possessions and dividends of stock of a domestic corporation which has derived no more than 20% of its income for the preceeding three years from sources within the United States constitute income from sources without the United States. Rev. Rul. 69-27, 1969 INT. REV. BULL. No. 4, at 16.

[96] *See* Letter from Martine H. Gordon to Inspector of Taxes, Profit Tax Dep't, Curacao, Netherlands Antilles, Oct. 11, 1968, on file in the Offices of the *Virginia Law Review* (nonresident debenture holder not "engaged in trade or business" nor having a "permanent establishment" within the Netherlands Antilles is not subject to inheritance or income taxes).

[97] For all purposes of the FDIR, a parent company and its domestic finance subsidiary are considered a single entity. 15 C.F.R. § 1000.323(b) (1969).

[98] 15 C.F.R. § 1000.324(a) (1969).

affiliate ordinarily would be treated as a transfer of capital from Schedule A to the direct investor[99] and as a further transfer by the direct investor to Schedule C.[100] Because of severe limitations on carryovers from Schedule A to Schedule C,[101] such a transaction could create a violation of the Regulations.[102] In addition to lending money to its parent, an offshore finance company may also transfer borrowed funds to affiliates of the parent in other scheduled areas. Inter-schedular transfers pose considerable difficulties in many instances since they are deemed to be transfers from the Schedule of the transferor to the direct investor and then transfers from the direct investor to the Schedule of the transferee.[103] The latter transfer could result in a violation of the Regulations, particularly when the transferor is a Schedule A company and the transferee is a Schedule B or C company.[104]

In light of this problem, the Office of Foreign Direct Investments issues private rulings[105] permitting bona fide offshore finance subsidiaries to treat funds borrowed abroad as proceeds of long-term foreign borrowing in the same manner as funds borrowed by domestic finance subsidiaries. The offshore finance company, however, is domesticated only to a limited degree. Transfers of capital made to capitalize offshore companies are subject to the restrictions on such transfers. In the case of a simple capital contribution, the parent's transfer would be offset by repatriation of funds borrowed by the offshore company. In the case of "bootstrap" capitalization[106] the funds borrowed abroad by the domestic parent to capitalize the offshore finance company will offset the capitalization transfer.[107] In addition to the restrictions on capital transfers, the offshore company is subject to repatriation of earnings re-

[99] 15 C.F.R. § 1000.312(b)(1) (1969).

[100] *Id.* § 1000.312(a)(7).

[101] *Id.* § 1000.504(c)(1), (2). For a more detailed analysis of the carryover provisions of the FDIR, see Lancaster, *FDIR*, at 126-31.

[102] *See* 15 C.F.R. §§ 1000.503-.504 (1969).

[103] *Id.* § 1000.505(a).

[104] *See* Kingson, *Investment*, at 16-17. See note 101 *supra.*

[105] It is understood that the Office of Foreign Direct Investments is working on regulations to permit the use of offshore finance companies without the need for specific authorization in each case.

[106] See text at notes 25-27 *supra.*

[107] In such a case the original transfer would be deemed a transfer of capital to the country in which the finance subsidiary was incorporated. 15 C.F.R. § 1000.312(a)(2) (1969). However, in computing net transfer of capital a direct investor is allowed to deduct "an amount equal to the proceeds of long-term foreign borrowings made by the direct investor during the year." *Id.* § 1000.313(d)(1).

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quirements[108] and the liquid foreign balance rules.[109] Consequently, a special exemption is needed if the company is to retain cash overseas without depositing it for more than twelve-month periods.[110]

CONCLUSION

Both domestic and offshore finance companies have been of inestimable value to large, publicly held American companies that desire to maintain their foreign investment programs without doing further immediate damage to the United States balance of payments position. Large debenture offerings do create future problems, however, since they must be repaid at a later date. Many of the debentures will be converted into stock, but conversion does not entirely solve the difficulty because the stock is readily marketable in the United States. Presumably, the market value of the stock will have risen well above the face value of the underlying debenture, creating the potential for an even greater dollar drain that simple redemption of the debt. Hopefully, our economy will remain strong and foreigners will retain their converted stock or be able to market it to other foreigners.

If the finance companies continue to proliferate or expand, the danger of future damage to United States balance of payments could lead to the indefinite retention of the controls. At the moment, however, the convertible debenture market is somewhat sour and debenture offerings have been reduced in size and number. According to one leading international business publication:

> The Eurobond market, easily the most important long-term capital source for international companies, is in agony, but this should not cause companies to conclude that its demise is near.
>
> The market, as it stands today, is riddled with paradoxes. The record high interest rates are too low for investors who can get 5 percentage points more in the short-term money market. But they are too high for the borrowers wanting long-term money. Conversion features have lost much of their attraction to European investors as a

108 Under *id.* § 1000.306(a)(2) the direct investor's share of an affiliated foreign national's earnings are treated as direct investment in the affiliated foreign national. If this amount would cause the year's direct investment to exceed the investor's allowable investment, the excess must be repatriated, either through dividends paid by the affiliated foreign national or negative transfers of capital. *See* Kingson, *Investment,* at 12-16.

109 15 C.F.R. §§ 1000.203(a)(2), 1000.203(c) (1969). See note 70 *supra.*

110 *See* 15 C.F.R. § 1000.203 (1969).

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> result of sharply declining stock markets that make any premium seem too high. At the same time, convertibles are now too expensive for corporations that will not dilute equity for a minute premium. To top everything, the secondary market for international bonds is becoming chaotic, with unexplainable price differences between issues of equal, or near equal, quality.[111]

Nevertheless, with a rebound in our stock market or a return to sane interest rates, convertible debentures could begin to issue forth in large numbers once again.

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[111] 16 BUSINESS INTERNATIONAL 201 (1969). *But see id.* at 230-31. The most recent report still shows that the Eurobond market is still having its problems. *Id.* at 335.

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