SELECTED UNITED STATES TAX ISSUES IN CROSS-BORDER SECURITIZATIONS

WILLYS H. SCHNEIDER*

I. INTRODUCTION

This Article discusses certain U.S. and related income tax issues that arise in what are generally referred to as "cross-border securitizations." The term "cross-border securitizations" covers securitization transactions in which the obligors, originator, "special purpose vehicle" (or "SPV"), and investors are in two or more jurisdictions. For example, a transaction may involve a U.S. originator that holds obligations of U.S. obligors and raises funds through a foreign SPV from foreign investors. Alternatively, the transaction might consist of a non-U.S. originator that holds obligations of U.S. or non-U.S. obligors and securitizes to foreign or U.S. investors. A securitization also might involve a guarantee or other credit enhancement from a foreign party related to the issuer of debt securities.

Tax issues in cross-border securitizations include those arising in purely domestic transactions, as well as certain foreign tax concerns. Depending on the location of the originator, the receivables, and the SPV, issues common to both U.S. and cross-border transactions (*e.g.*, sale versus loan of receivables or entity-level tax on the SPV) may have to be determined under foreign, in addition to or instead of, U.S. law.[1] This Article describes tax issues unique to cross-border situations.

*Partner, Kaye, Scholer, Fierman, Hays & Handler, LLP.

1. If a "financial asset securitization investment trust" (or "FASIT") is used in a securitization transaction, the sale versus loan and entity-level tax issues do not arise under U.S. law. A FASIT is a new and unique tax vehicle that is governed by a specific set of rules contained in Sections 860H through 860L of the Internal Revenue Code ("I.R.C."). [Hereinafter, all Section references are to the I.R.C.] While U.S. rules on FASITs do not apply for purposes of non-U.S. law, FASITs could be used in the United States to hold non-U.S. obligations or to issue interests to foreign investors, subject to certain limitations. *See* I.R.C. §§ 860K, 860L(a)(1)(C), and 860L(b)(1)(B). Although FASITs came into effect September 1, 1997, regulations that had been expected by that date and that are needed to clarify a number of points in the statutory provisions have not yet been issued. Accordingly, although at least one FASIT transaction has been consummated, widespread use likely will await issuance of regulations.

II. WITHHOLDING TAX

A. General Rules

In a securitization transaction, payments treated as interest for income tax purposes may be subject to U.S. or foreign withholding taxes, whose cost must be factored into the transaction. Withholding taxes may arise in the following situations: (i) if there is a tax sale of receivables with obligors in one country paying interest on the underlying obligations to an SPV or investors in another country; (ii) if a transaction between the originator in one country and an SPV or ultimate investor in another country is treated as a tax loan to the originator; or (iii) if an SPV in one country raises money by issuing debt to holders in another country.

The United States and many other countries impose a withholding tax on the gross amount of interest paid to certain foreign persons not otherwise engaged in business in the country from which the interest is paid. The U.S. withholding tax rate on interest is thirty percent,[2] subject to a statutory exemption for "portfolio interest."[3] The portfolio interest exemption applies to interest paid on registered obligations, and to bearer obligations that are targeted to non-U.S. investors.[4] Portfolio interest does not include interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business,[5] nor does it include interest received by parties owning ten percent or more of the interests in a debtor corporation or partnership.[6] Portfolio interest also does not refer to interest determined by reference to (i) receipts, sales or other cash flow of the debtor or a related person; (ii) any income or profits of the debtor or a related person; or (iii) any dividend, partnership distributions or similar payments made by the debtor or a related person (so called "contingent interest").[7] The portfolio interest exemption thus applies only in certain securitization transactions. Accordingly, U.S. as well as non-U.S. withholding tax remains a factor to be considered in structuring cross-border securitizations.

2. *See* I.R.C. §§ 1441, 1442 (1994).
3. *Id*. §§ 871(h), 881(c).
4. *See id*. § 881(c)(3)(A).
5. *See id*.
6. *See id*. §§ 871(h)(3)(B), 881(c)(3)(B).
7. *Id*. §§ 871(h)(4), 881(c)(4).

Any applicable withholding tax generally is withheld by a payor on behalf of a payee and paid over to the appropriate taxing authority.[8] Frequently, this withholding tax is reduced or eliminated pursuant to the terms of an income tax treaty between the countries of the payee and the payor.[9] In many instances, however, no treaty relief is available.[10] If the withholding tax is not eliminated, it is necessary to determine which party will bear its cost. In most cases, the borrower will assume the withholding tax burden by means of a "gross-up" provision under which the borrower pays the lender an extra amount as compensation, on an after-tax basis, for the tax withheld.[11]

8. The U.S. Internal Revenue Service (the "IRS") has recently issued new regulations that simplify the responsibilities of U.S. withholding agents and the means of identifying entitlement to exemptions from U.S. withholding tax. The regulations do not substantively change the incidence of such withholding tax with respect to securitization or other transactions. *See, e.g.*, Treas. Reg. § 1.1441-1(e) (as amended in 1997) (discussing withholding agent's reliance on beneficial owner withholding certificates, intermediary withholding certificates, qualified intermediary withholding certificates, and certain presumptions available to withholding agents for purposes of treating a payee as foreign or domestic). The new withholding regulations are effective for payments made on and after January 1, 1999.

9. For example, income tax treaties between the United States and Germany, the United States and the United Kingdom, and the United States and France eliminate withholding tax on interest. *See* Income Tax Convention, July 22, 1954, U.S.-F.R.G., art. 7, 5 U.S.T. 2768, 2784 [hereinafter U.S.-German Treaty]; Convention between the Government of the United States and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Dec. 31, 1975, U.S.-U.K., art. 11, 31 U.S.T. 5668, 5680; Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Aug. 31, 1994, U.S.-Fr., S. TREATY DOC. NO. 103-32 (1995). Treaties between the United States and Italy and the United States and Japan, on the other hand, only limit the rate that can be imposed to 15% and 10%, respectively. *See* Income and Capital Tax Convention, Apr. 17, 1984, U.S.-Italy, art. 11, T.I.A.S. No. 11064; Convention Between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 8, 1971, U.S.-Japan, art. 13, 23 U.S.T. 967, 990.

10. For example, although no tax treaties are in force between the United States and any Latin American nation except Mexico, there is interest in negotiating with Brazil and Venezuela and the United States has signed, but not ratified, a treaty with Argentina. *See* Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 18, 1992, U.S.-Mex., S. TREATY DOC. NO. 103-7 [hereinafter U.S.-Mexican Treaty]; s*ee also* Richard Mitchell, Note, *United States-Brazil Bilateral Income Tax Treaty Negotiations*, 21 HASTINGS INT'L & COMP. L. REV. 209, 209 (1997); Robert F. Hudson & Gregg D. Lemein, *U.S. Tax Planning for U.S. Companies Doing Business in Latin America*, U. MIAMI INTER-AM. L. REV. 233, 237 (1995-1996); S. EXEC. REP. NO. 97-44, at 30 (1981).

11. *See* Willys H. Schneider, *Selected Tax Issues Affecting Domestic and Cross-Border Securitizations Transactions*, in TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS AND RESTRUC-

B. U.S. "Conduit" Regulations

In most securitization transactions, attempts are made to structure the deal to avoid withholding tax, an added cost that benefits none of the parties involved. For example, establishing an SPV in a tax haven jurisdiction or in a jurisdiction with a beneficial tax treaty network can help minimize withholding tax. This is generally not difficult with respect to payments flowing out of a non-U.S. SPV resident in such a jurisdiction. But where payments to the SPV originate in the United States, "conduit" regulations provide an additional issue to consider.[12] Under these regulations, if tax avoidance constitutes a principal purpose of a transaction, back-to-back loans and other arrangements using an SPV in an intermediary jurisdiction (so-called "financing arrangements"),[13] can be recharacterized by ignoring the SPV's participation in the transaction, which results in increased U.S. withholding tax.[14]

In particular, an SPV or other intermediate entity's participation in a transaction can be ignored under the conduit regulations: (i) if such participation reduces the withholding tax that would have applied in the absence of such participation; (ii) if the intermediate entity participates pursuant to a tax avoidance plan, *i.e.*, a plan designed in part to avoid withholding tax; and (iii) if either the intermediate entity is related to the financing entity, or where no relation exists, if the intermediate entity would not have participated in the financing

TURINGS 230 (Practising Law Institute ed. 1997)

12. *See* Temp. Treas. Reg. § 1.881-3 (1995). Only the IRS may use these rules, because taxpayers are not permitted to disregard the form of their transactions. *See id*. § 1.881-3(a)(3)(iii).

13. *See id*. § 1.881-3(a)(2)(i) (defining "financing arrangement" as a series of transactions by which one person (the "financing entity") advances money or other property, or grants rights to use property; and another person (the "financed entity") receives money, other property, or rights to use property, if the advance and receipt are effected through one or more intermediate entities and (except for certain cases involving two or more related persons), there are "financing transactions" (including debt and certain equity as described in note 15 *infra*), linking the three entities).

14. *See id*. § 1.881-3(b). Tax avoidance will be deemed a principal purpose under the conduit regulations even if it is outweighed by other purposes, and regardless of whether the plan is formal or informal, written or oral. However, the plan must be in existence as of the date the relevant transactions are entered into, and all relevant evidence is weighed in determining whether there is a tax avoidance plan. This evidence includes: (i) taking into account whether the participation of the intermediate entity results in a significant reduction of tax; (ii) whether the intermediate entity had sufficient funds valuable to make an advance without regard to any advance to it; (iii) the time period between the steps in a transaction; and (iv) if the parties are related, whether the financing transaction occurs in the ordinary course of integrated trade or businesses conducted by such parties. *See id*.

arrangement on substantially the same terms but for the fact that the financing entity engaged in the transaction with the intermediate entity. This latter scenario often is referred to as the "but for" test.[15] Under the current version of these regulations, such recharacterization may be avoided if the SPV is funded with certain types of equity. However, in many securitization transactions, investors will hold instruments that, whether or not actually denominated as equity, contain redemption rights or other similar features that will elicit their treatment as part of a financing arrangement for purposes of the conduit regulations.[16]

The conduit regulations require consideration in the following instance in which an intermediate entity or SPV is formed in a jurisdiction subject to a tax treaty with the United States that eliminates withholding tax on interest (*e.g.*, the United Kingdom). Assume that the SPV lends to a U.S. person (or acquires a pool of debt obligations of U.S. obligors), and that the SPV is funded by investors, including banks, that reside in another jurisdiction that either has no tax treaty with the United States (*e.g.*, Saudi Arabia) or has a tax treaty that reduces, but does not eliminate, the withholding tax (*e.g.*, Italy). Even if this structure were primarily designed to achieve non-U.S. tax advantages, because a direct payment of interest from the U.S. borrower to the foreign banks could be subject to U.S. withholding tax (*i.e.*, as noted above, the portfolio interest exemption may not apply to banks), the transaction still could be subject to scrutiny under the conduit regulations.[17] Nonetheless, it may be possible to avoid the impact of these regulations by demonstrating that the banks' investment in the SPV does not constitute an extension of credit pursuant to a loan agreement made in the ordinary course of its trade or business. The investors may be asked for representations to this effect in

15. *See id*. § 1.881-3(a)(4)(i).

16. *See id*. § 1.881-3(a)(2)(ii)(B). Corporate stock or a similar interest in a partnership or trust will be treated as a "financing transaction" that constitutes part of a "financing arrangement": (i) if the issuer is required to redeem the interest at a specified time, or if the holder has the right to require such redemption or the making of a similar payment; (ii) if the issuer has the right to redeem, and such redemption is, based on facts and circumstances as of the issue date, more likely than not to occur; or (iii) if the owner of the interest has a put right involving a person related to the issuer or acting pursuant to a plan or arrangement with the issuer. *See id*.

17. As noted above, the conduit regulations contain a rule stating that whether participation of the intermediate entity has resulted in a significant reduction of tax will be taken into account in determining whether there is a tax avoidance plan, a finding necessary to trigger application of the regulations. *See supra* note 14.

order to avoid imposition of penalties for failure to withhold.[18]

If there is a public offering of interests in the SPV to fund an SPV's loan to a U.S. obligor (or purchase of U.S. obligations), the "but for" test contained in the regulations[19] should prevent penalty imposition. In such an instance, one would argue that the fact that some banks in non-treaty or unfavorable treaty jurisdictions may purchase a portion of publicly offered investments is merely serendipitous, and, therefore, that the SPV would have participated in the transaction regardless of whether such investors had been involved. If the facts preclude this argument, it may be advisable to restrict sales of interests in the SPV to non-banks or banks in treaty jurisdictions that eliminate the withholding tax.

With regard to non-bank investors, to the extent that a direct receipt of interest from the U.S. obligor would be eligible for the portfolio interest exemption from withholding tax (*i.e.*, that the amounts in question constitute interest that qualifies for such exemption), there would be no significant reduction in tax attributable to the SPV's participation, and the conduit regulations should not apply.

C. Tax Treaty Limitation of Benefits Provisions

Distinct from the conduit regulations, the "limitation of benefits" provisions contained in many tax treaties between the United States and other countries may restrict the availability of reduced treaty rates to recipients who do not maintain significant contacts with the treaty jurisdiction in question. For the past several years, U.S. tax treaty policy has insisted on such provisions. Although the specific treaty provisions vary, their general thrust is to counteract so-called "treaty shopping" by restricting benefits to entities that are either publicly traded, engaged in significant business activities in their home jurisdiction, or beneficially owned by residents of such jurisdiction.[20]

18. *See id*. §§ 1.881-3(a)(3)(ii)(A), (D) (stating that recharacterization of transaction under conduit regulations applies for purposes of liability for failure to withhold); Prop. Treas. Reg. §§ 1.1441-7(d), 62 Fed. Reg. 53504 (1997) (discussing liability of withholding agents in conduit financing arrangement situations); I.R.C. §§ 6651, 6721 (1994) (discussing penalties for failure to withhold and to file related information returns).

19. *See supra* text accompanying note 15.

20. *See, e.g.*, U.S.-German Treaty, *supra* note 9, at X art. 28 (stating that persons eligible for treaty benefits include only resident individuals; the country itself (or a subdivision or local authority thereof); a resident engaged in an active business in its resident country; a publicly traded company; a company, more than 50% of which is owned by persons entitled to treaty benefits and less than 50% of the gross income of which is used to meet liabilities of persons

For example, under the facts assumed above, if the SPV were in Ireland, whose recently ratified treaty with the United States includes a limitation of benefits provision, there could, depending upon the status of the intermediate entity, be a withholding tax issue without regard to the conduit regulations.[21] On the other hand, to the extent that the portfolio interest exemption applied (*i.e.*, assuming no related parties or contingent interest and no issues as to bank investors), there would be no withholding tax.

III. TAXATION OF SPV AND ITS SHAREHOLDERS

A. Taxation of SPV

As noted above, it may be desirable to locate an SPV involved in a cross-border securitization in a tax haven jurisdiction. Locating the SPV in such a jurisdiction both minimizes withholding tax on any interest payments made by the SPV and avoids mainstream tax on net income of the SPV. However, use of a tax haven also may increase the potential withholding tax burden on any interest payments to be made to the SPV because of the potential application of the conduit regulations with respect to U.S.-source payments, and the fact that tax havens typically are not parties to tax treaties that may reduce or eliminate withholding tax. Aside from the foregoing, it also is important to ensure that the SPV will not be subject to any mainstream net income tax in a jurisdiction other than that in which it is actually resident.

For example, if an SPV operating in one jurisdiction purchases a pool of receivables from an originator, the obligors (which are in an-

not entitled to such benefits or a tax-exempt entity); U.S.-Mexican Treaty, *supra* note 10, at art. 17 (which is similar to the U.S.-German Treaty with additional special rules relating to entities owned by any country that is a party to the North American Free Trade Agreement and to qualification for reduced rates on dividends, interest and royalties); *see also* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Dec. 18, 1992, U.S.-Neth., S. TREATY DOC. NO. 6 (1993), art. 26 (having lengthy and heavily negotiated limitation of benefits provisions, including rules similar to those described above but also special rules aimed at eliminating the use of Holland as a jurisdiction to set up "conduit" entities with no purpose other than avoiding withholding tax (*i.e.*, effectively a precursor to conduit regulations), and dealing with ownership by one or more European Community nation(s)).

21. Under the U.S.-Irish Treaty, if the intermediate entity were publicly traded, the limitation of benefits article would not apply. If not, its ownership by non-Irish persons could make it ineligible for treaty benefits. *See* Convention between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, July 28, 1997, U.S.-Ir., art. 23, S. Treaty Doc. No. 31, 105th Cong., 1st Sess. (1997).

other jurisdiction) and the originator, service the receivables in that jurisdiction on behalf of the SPV. A question thus arises as to whether the SPV will be deemed to have a presence in that jurisdiction, sufficient to subject it to mainstream income tax. In the United States a non-U.S. SPV that is deemed to be "doing business" in the United States will, subject to a safe harbor for investments described below, be subjected to net U.S. income tax on income related to such business.[22] Generally, this should not be a problem if the servicer is performing purely ministerial functions, has no power to bind the SPV in any way (*e.g.*, by virtue of being able to agree to changes in the terms of the receivables), and if the SPV is not otherwise managed or controlled outside of its home jurisdiction. In addition, most income tax treaties contain provisions protecting a foreign entity against net income tax unless the entity has a "permanent establishment" in the jurisdiction in question. Typically, a "permanent establishment" can be avoided if there is no office and are no employees in such jurisdiction.[23] As noted above, however, an SPV in a tax haven will not be eligible for treaty relief.

In view of the fact that cross-border securitization transactions frequently involve non-U.S. SPVs, it will be important to assure that they not be subject to net income tax in the United States. The I.R.C. contains a safe harbor (hereinafter referred to as the "investment safe harbor") which can be critical to achieving this goal. Under the investment safe harbor, a person will not be deemed engaged in a U.S. trade or business (and, therefore, not subject to net U.S. income tax)[24] if its sole activities consist of effecting transactions in stocks or securities for its own account.[25]

22. *See* I.R.C. § 882 (1994) (dictating foreign corporation engaged in business within the United States be taxed as U.S. taxpayer on income effectively connected with the conduct of a trade or business within the United States).

23. *See, e.g.*, Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Dec. 18, 1992, U.S.-Neth., art. 5, S. TREATY DOC. No. 6, 103d Cong., 1st Sess. (1993), 32 I.L.M. 462 (1993) [hereinafter U.S.-Netherlands Treaty]; U.S.-Sweden Income Tax Treaty, art. 5, Sept. 1, 1994, Tax Treaties (CCH) ¶8801, Tax Treaties (WGL) ¶81,030 [hereinafter U.S.-Sweden Treaty]; Convention Between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 8, 1971, art. 9, 23 U.S.T. 967 [hereinafter U.S.-Japan Treaty] (permanent establishment includes a place of management, branch, office or factory or the presence of dependent agents with authority, habitually exercised, to conclude contracts in name of off-shore enterprise; limited use of facilities, *e.g.*, display, storage, maintenance of merchandise or for purchases of merchandise or collecting information, do not constitute a permanent establishment).

24. *See supra* note 21.

25. *See* I.R.C. § 864(b)(2)(A)(ii). Until this year it was necessary, in order to qualify un-

If the SPV is buying many different obligations, including loans and loan participations, over a period of time, as may be the case in so-called "collateralized loan obligation" (or "CLO") transactions, concern arises as to whether the SPV is engaged in some sort of a financing business that goes beyond the investment safe harbor just described. In such cases, and in the absence of any clear authority on this issue, certain guidelines are generally observed to minimize the risk of U.S. tax.[26] These include, for example, restricting the SPV to buying loans only in the secondary market, and not in initial offerings; not permitting an investment advisor or other agent of the SPV to negotiate the specific terms of loans in which participations by the SPV are taken; restricting the extent to which an SPV can participate in a refinancing of an existing loan; and/or making sure that the SPV receives no amounts denominated as fees that could be construed as having been received for performance of services, rather than as pure compensation for use of money (*e.g.*, an origination fee versus a fee to induce a creditor to waive certain loan agreement covenants).[27]

Anticipated guidelines in the FASIT area may prove useful with respect to these issues affecting non-U.S. SPVs. In particular, FASITs effectively are barred from the "origination" of loans by vir-

der this safe harbor, for the "principal office" of the offshore entity not to be in the United States. This could be achieved if certain enumerated functions, often referred to as the "ten commandments," were performed off-shore. This requirement was repealed, effective January 1, 1998.

26. As indicated above, these and other guidelines have emerged in the absence of any clear authority as to what constitutes the conduct of a financing business that would be deemed to deprive a non-U.S. taxpayer of protection under the investment safe harbor. A similar problem exists in other contexts under the I.R.C. *See, e.g.*, Temp. Treas. Reg. § 1.892-4T(c)(ii) and (iii) (1988) (effecting transactions in stocks, securities or commodities for a foreign government's own account does not constitute a "commercial activity" and a foreign government's income from such activities is thus exempt from U.S. income tax, but investments (including loans) made by a "banking financing or similar business" do constitute commercial activities yielding taxable income to a foreign government; no definition of "banking financing or similar business"); I.R.C. § 7704(d)(2) (1994) (exception from corporate tax treatment for publicly traded partnerships with significant passive income, including interest, does not apply to interest derived in the conduct of a "financial or insurance business"; no definition of "financial or insurance business"). *Cf.* Prop. Treas. Reg. § 1.7704-3(b), 62 Fed. Reg. 66575 (1997) (qualifying (passive) income does not include income derived in the ordinary course of a trade or business and, for purposes thereof, income derived from an asset with respect to which the partnership is a broker, market maker or dealer is treated as so derived, as opposed to income derived from an asset with respect to which the taxpayer is a trader or investor).

27. The latter draws support from one aspect of the FASIT rules, *i.e.*, that receipt of fees or other compensation for services are effectively prohibited by virtue of triggering a 100 percent tax thereon, whereas fees received as compensation for a "waiver, amendment or consent" under debt obligations held by the FASIT are not subject to this tax. *See* I.R.C. § 860L(e)(2)(D) (1994); *see also* text accompanying note 27 *infra*.

tue of the fact that any net income derived from such activity is subject to a one hundred percent tax.[28] The term "origination" appears nowhere else in the I.R.C. It is conceivable that upcoming FASIT regulations will contain some definition of the term or other guidance that could be looked to, by analogy, in determining what actions an SPV could take with respect to U.S. loan transactions before it is treated as engaged in a U.S. trade or business for purposes of the rules described above.

Another factor to take into account are potential U.S. state and local income taxes. Many states, for example, do not contain an investment safe harbor against imposition of their income tax. Thus, care always must be taken to avoid a presence in a particular state.[29]

B. Taxation of SPV Shareholders

If the SPV is a foreign corporation owned by U.S. shareholders, one also must take account of certain so-called "anti-avoidance" provisions of the I.R.C. These include the Sub-part F rules on

28. *See* I.R.C. § 860L(e)(2)(C) (1994).

29. The State of New York, for example, does not at this point allow an investment safe harbor. The only similar rule that exists for New York purposes is relevant to foreign corporations that may be partners in a "portfolio investment partnership," defined as a limited partnership, that is not a securities dealer (as defined in Section 1236) and at least 90 percent of the gross income of which is derived from dividends, interest, payments with respect to securities loans, and gains for the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investing in such stock, securities or currencies. *See* N.Y. COMP. CODES R. & REGS. tit. 20, § 1-3.2(a)(6)(iii)(d) (1997); 19 R.C.N.Y. § 11-06(d) (1997); I.R.C. § 851(b)(2) (1994). Such partners are exempt from the general rule that would otherwise subject a foreign corporation to the New York corporate franchise tax if it is a partner in a partnership doing business or employing capital in New York. Unless that rule is applicable, therefore, it is critical, at a minimum, that a non-New York corporation not employ capital, own or lease property, or maintain an office in New York in order to avoid New York state and city income tax. *See* N.Y. TAX LAW § 209(1) (McKinney 1997); N.Y. COMP. CODES R. & REGS. tit. 20, § 1-3.2(a) (1997); N.Y.C. Admin. Code § 11-603(1) (1997); 19 R.C.N.Y. § 11-03 (1997). Such tax can also apply, however, if the corporation is otherwise deemed to be "doing business" in New York, a somewhat ill-defined term. *See* N.Y. TAX LAW § 209 (1997); N.Y. COMP. CODES R. & REGS. tit. 20, § 1-3.2(a)(1)(i) and § 1-3.2(b) (1997); N.Y.C. Admin. Code § 11-603(1) (1997); 19 R.C.N.Y. § 11-03(a)(1)(i) and § 11-03(b) (1997). Maintaining New York bank accounts, hiring a broker to perform acts incidental to the safekeeping of such accounts, having non-employee directors with New York offices or keeping books and records on New York, if such books and records are not kept by employees, should not be problematical. *See* N.Y. TAX LAW § 209(2) (McKinney 1997); N.Y. COMP. CODES R. & REGS. tit. 20, § 1-3.3 (1997); N.Y.C. Admin. Code § 11-603(2) (1997); 19 R.C.N.Y. § 11-04(c) (1997). However, the fewer functions that are performed in New York the better. In particular, it is advisable not to hold corporate meetings in New York, or to permit officers or other employees to take actions there that bind the corporation. *See* N.Y. COMP. CODES R. & REGS. tit. 20, § 1-3.2(f) ex. 1 (1997); 19 R.C.N.Y. § 11-03(f) ex. 1 (1997).

"controlled foreign corporations" (or "CFCs"), *i.e.*, foreign corporations over fifty percent of the vote or value of which are held by ten percent or more U.S. shareholders, and the "passive foreign investment company" (or "PFIC") rules.[30] Significantly, these rules can apply either to actual equity owners or to owners of subordinated debt that is or may be characterized as equity for U.S. income tax purposes.[31]

Under the Subpart F rules,[32] certain earnings (including, *inter alia*, interest, dividends and gains from sales of securities) of a CFC may be treated as taxable to U.S. shareholders who own ten percent or more of the CFC even if such earnings are not actually distributed. In addition, if a CFC's assets are pledged to secure a U.S. shareholder's debt, or such debt is guaranteed by the CFC or at least two-thirds of the CFC's voting stock is used to secure the debt and the stock pledge is accompanied by one or more negative covenants or similar restrictions, deemed dividends may result.[33] Thus, for example, if an SPV is a CFC and buys receivables from a related U.S. originator in a tax loan transaction, deemed income can be triggered to ten percent or more U.S. shareholders of the SPV even if no cash is actually received by them.

Under the PFIC rules, any U.S. shareholder of a foreign SPV that is a PFIC (*i.e.*, that primarily has passive income) may, whether or not the U.S. shareholders are in control of the SPV, be liable for an interest charge on the tax on dividend distributions from the SPV

30. Under a recently enacted rule, a PFIC that is also a CFC will, with respect to periods after December 31, 1997, not be treated as a PFIC with respect to 10 percent shareholders who are subject to the Subpart F rules, as described above. *See* I.R.C. § 1297(e) (1994). In addition, under the foreign personal holding company rules, passive income of a closely held foreign SPV can be imputed to U.S. shareholders. This arises only, however, if the SPV is controlled, directly or indirectly, by five or fewer U.S. individuals and, therefore, will be irrelevant in most securitization transactions. *See id.* §§ 551-558.

31. There is no bright-line test that applies in determining whether an instrument is properly viewed as debt or equity for U.S. income tax purposes. The authority that does exist generally relies on a number of factors, including, *inter alia*, whether there is a definite maturity date and, if so, the length of the term of the instrument; whether there is a market rate of interest, payable on fixed dates; the security for the obligation; whether the issuer is thinly capitalized; identity of interest between creditors and equity owners; and the form of the transaction and the intent of the parties. *See, e.g.*, John Kelley Co. v. Commissioner, 326 U.S. 521 (1946) (explaining that debt/equity inquiry depends on particular factors, no one of which is exclusive). In certain securitization transactions interests in a thinly capitalized SPV that are denominated as indebtedness but are, for example, deeply subordinated to other debt, may be treated as equity, as opposed to debt, under U.S. principles. A more detailed discussion of this issue is beyond the scope of this Article.

32. *See* I.R.C. §§ 951-64 (1994).

33. *See id.* at § 956(d); Treas. Reg. § 1.956-2(c) (as amended in 1988).

that are attributable to earnings accumulated in the prior year and, therefore, with respect to which U.S. tax has been deferred.[34] In addition, gains on sales of PFIC stock are susceptible to being taxed as ordinary income rather than capital gain, to the extent attributable to accumulated earnings, and tax on such gain also can be subject to the interest charge just described.[35]

The interest charges and ordinary income treatment of sale gain can be avoided if a so-called "qualifying electing fund" or "QEF" election is made to recognize taxable income, with respect to a U.S. shareholder's share of the earnings of the SPV, on a current basis, *i.e.*, even in the absence of distributions.[36] Alternatively, the interest charge and ordinary income treatment of sale gain generally can be avoided if, in the case of "marketable" PFIC stock, an election is made to mark the stock to market on an annual basis and take into account as ordinary income any appreciation in the value thereof.[37]

In a transaction in which distributions will be made by a PFIC on a current basis, a QEF election makes sense. In such case there also is a further election that can be made whereby, if the SPV/PFIC does not distribute all of its earnings in a taxable year, payment of some or all of the taxes on the SPV's income can be deferred, subject to an interest charge on the deferred amount.[38] This would be advisable, for example, where debt instruments owed by the SPV carry "original issue discount" ("OID"), requiring income accrual in the absence of cash (so-called "phantom income").

IV. "EARNINGS STRIPPING"

Under the so-called "earnings stripping" rules of Section 163(j) of the I.R.C., a U.S. corporate borrower may be limited as to the extent to which it can claim deductions, on a current basis, for interest expense. Interest expense subject to potential limitation under these provisions includes debt owed to related persons who are wholly or partially exempt from U.S. federal income tax (including, in particu-

34. *See id.* §§ 1291-1297.

35. *See id.* § 1291(a).

36. *See id.* §§ 1291(d)(i), 1293.

37. *See id.* §§ 1291(d)(1), 1296. "Marketable stock" is defined for this purpose as stock regularly traded on a national securities exchange or national market system or any exchange or other market which is determined to have rules adequate to carry out the purposes of the mark-to-market provisions; foreign stock, to the extent provided in regulations; and, to the extent provided in regulations, any option on stock of the type described above. Special rules also apply in the case of certain "regulated investment companies." *See id.* § 1296(e).

38. *See id.* § 1294.

lar, related non-U.S. entities exempt from withholding tax under an applicable tax treaty),[39] or debt guaranteed (whether via a formal guarantee or "comfort letter" or other arrangement)[40] by such person.[41] The "earnings stripping" provisions apply if the corporation has a debt-to-equity ratio in excess of 1.5 to 1 and if its interest expense in a given taxable year exceeds a prescribed threshold.[42]

The earnings stripping rules should apply in securitization transactions only to the extent that the transfer of receivables is viewed as a loan, as opposed to a sale, for tax purposes, since in a sale transaction there is no interest expense (although there may be a loss on the sale of receivables). To date, there is no provision treating such a loss as interest for purposes of the "earnings stripping" provisions. Proposed regulations have reserved this issue.[43] Note, however, that if a sale of receivables is made to a purchaser that is related to the seller, *i.e.*, if there is over fifty percent common ownership, a loss on the sale would be disallowed under Section 267(a).

If a securitization transaction does involve a tax loan, the earnings stripping rules could apply if, for example, the loan is guaranteed by a foreign parent of the originator/borrower. Only guarantees of

39. Interest that is subject to U.S. withholding tax at a reduced treaty rate is treated for this purpose as not subject to U.S. tax to the extent of the proportion of the U.S. withholding tax rate under the applicable treaty to the statutory withholding tax rate. *See id.* § 163(j)(5)(B). For example, if the U.S. statutory withholding tax rate is 30 percent and the applicable treaty rate is 15 percent (as in the case of payments to an Italian investor), one-half of the interest paid or accrued to a resident of the treaty country will be considered as not subject to U.S. federal income tax.

40. *See also* note 43 *infra*.

41. The provisions with respect to guaranteed debt do not apply, (i) to the extent provided in regulations, if the guarantor would have been subject to tax, on a net income basis, had interest been paid to it; or (ii) if the borrowing taxpayer owns at least 8 percent of the guarantor. A loan guaranteed by a foreign affiliate subject to a full U.S. withholding tax (as opposed to a net income tax) could, however, be subject to the earnings stripping rules. In this connection, note that the portfolio interest exemption does not apply to loans by affiliated entities. *See supra* text accompanying note 6.

42. *See* I.R.C. § 163(j)(2) (1994). Specifically, current interest deductions will be denied if the corporation's net interest expense in a given year exceeds 50 percent of its "adjusted taxable income" (taxable income computed with certain adjustments, including ignoring net interest expense, any net operating loss deduction, or any depreciation, amortization or depletion deduction) for such year. Disallowed interest expense may be carried forward and deducted in the taxable year in which the corporation has net interest expense in an amount less than 50 percent of its adjusted taxable income.

43. *See* Prop. Treas. Reg. § 1.163(j)-2(e)(3), 56 Fed. Reg. 27907 (1991); *cf.* Temp. Treas. Reg. § 1.861-9T(b)(3) (1988) (treating losses on sale of certain receivables treated as equivalent to interest expenses for purposes of source of income rules). The latter provision limited the ability to use securitizations to maximize utilization of foreign tax credits by multi-national corporations by maximizing foreign source income.

underlying credit risk with respect to transferred receivables, however, as opposed to guarantees of performance, or warranties as to the nature and quality of receivables, presumably should trigger application of the earnings stripping rules in such case.[44]

V. OTHER ISSUES

Other U.S. tax issues that may arise in cross-border securitizations include: i) generation of currency gains or losses under I.R.C. Section 988 (to the extent, for example, that a U.S. party to a transaction is entitled to receive (or required to pay) amounts in currency other than U.S. dollars);[45] ii) potential withholding tax on swap payments where swaps are entered into to hedge interest rate risk; or iii) potential transfer price adjustments under Section 482, where sales or other transfers take place between affiliated parties in different jurisdictions.

A. Currency Gains and Losses

Currency gains or losses arise where a taxpayer or a "qualified business unit"[46] either engages in one of four specified transactions[47] that are denominated in a currency other than the taxpayer's "functional"[48] currency ("nonfunctional currency"), or disposes of a

44. The legislative history of section 163(j) indicates that a guarantee for this purpose includes any arrangement under which a person directly or indirectly assures, on a conditional or unconditional basis, the payment of another's obligation under any indebtedness. *See* H.R. Rep. No. 103-111, at 686 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 917. A guarantee of performance by the parties, which does not ensure payment on the underlying receivables, should, therefore, not trigger an earnings stripping issue.

45. Section 988 prescribes special, detailed, rules with respect to the federal income tax treatment of exchange gains or losses from transactions denominated in a currency other than the taxpayer's "functional" currency, *i.e.*, other than the U.S. dollar or other currency in which the taxpayer's books and records are kept.

46. A "qualified business unit" is defined as any separate and clearly identified unit of a trade or business of a taxpayer that maintains separate books and records. *See* I.R.C. § 989(a) (1994).

47. These transactions are: (i) the acquisition of a debt instrument; (ii) becoming an obligor under a debt instrument; (iii) accruing (or otherwise taking into account) any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account; and (iv) entering into, or acquiring any forward contract, futures contract, option or similar financial instrument. *See* I.R.C. § 988(c) (1994). Thus lenders or borrowers in securitizations where multiple currencies are involved can be affected by the rules of Section 988.

48. Under Section 985, a taxpayer's "functional" currency is the U.S. dollar, or, in the case of a qualified business unit, the currency of the economic environment in which a significant part of that unit's activities are conducted and which is used by that unit in keeping its books and records. *See* I.R.C. § 985 (1994).

nonfunctional currency (a "Section 988 transaction"). A currency gain or loss from a Section 988 transaction is equal to that portion of the gain or loss realized on such transaction by reason of a change in exchange rates on or after the booking date (*i.e.*, the date on which payment is made or received). Section 988 prescribes certain timing, character and source consequences for currency gains or losses associated with a Section 988 transaction, which are applied separately to each Section 988 transaction of a taxpayer. Generally, with respect to currency gains or losses, Section 988 applies the general realization and recognition provisions of the I.R.C., characterizes such gains or losses as ordinary income or loss, and sources such gains and losses by reference to the taxpayer or qualified business unit's residence. With respect to Section 988 transactions that are part of a hedging transaction that qualifies for "integrated" treatment under the applicable regulations, however, the above rules do not apply separately to each Section 988 transaction. Instead such transactions are treated as a single instrument for all purposes (including characterization and sourcing of gains or losses derived).[49]

B. Swap Payments

U.S. regulations provide that swap payments (including currency swaps) to foreign counterparties not engaged in a U.S. trade or business do not generally constitute U.S. source income, and thus, generally are not subject to U.S. withholding tax.[50] However, non-periodic payments made to U.S. counterparties pursuant to a swap agreement may, if treated as loans, give rise to U.S. source interest income. In particular, a "significant" non-periodic payment may be treated as a loan to the U.S. counterparty and the time value component associated with such loan must be recognized as U.S. source interest for all

49. *See* Treas. Reg. § 1.988-5, which provides integrated treatment for three categories of hedging transactions: (i) hedging transactions associated with debt instruments; (ii) hedging transactions which involve executory contracts to pay nonfunctional currency in the future with respect to ordinary course purchases or the performance of services; and (iii) hedging transactions which are intended to reduce the risk of currency fluctuations between the trade and settlement dates with respect to the purchase or sale of publicly traded stock or securities by a cash basis taxpayer.

50. *See* Treas. Regs. §§ 1.863-7(b) (as amended in 1991); 1.1441-4(a)(3) (as amended in 1997); I.R.C. § 988(a)(3) (1994); Treas. Reg. § 1.988-4 (as amended in 1992). However, currency swap payments integrated with a debt investment pursuant to Treas. Reg. § 1.988-5 could constitute U.S. source income (and thus would be subject to U.S. withholding tax) if payments on the underlying debt instrument constitute U.S. source income. *See* Treas. Reg. § 1.988-5 (as amended in 1997).

purposes of the I.R.C.[51] Although what is "significant" for these purposes is not specifically defined, an example in the applicable regulations provides that a non-periodic payment is significant if it exceeds forty percent of the present value of the fixed payments under the swap agreement.[52] Thus, if a swap agreement provides for a non-periodic payment and a foreign counterparty making the payment (which is treated as a loan) cannot claim the benefits of the portfolio interest exemption or an applicable income tax treaty, the U.S. source interest income deemed to arise with respect to the significant non-periodic payment could be subject to U.S. withholding tax.

C. Transfer Pricing

Transfer pricing issues could arise, for example, if there are multiple SPV's in different jurisdictions, or if receivables being sold arise from sales between U.S. and non-U.S. affiliates. In certain cases, this can result in imputation of additional income (or disallowance of a deduction) to a U.S. taxpayer.[53]

VI. CONCLUSION

This Article has demonstrated some of the important and unique tax issues which develop from the intersection of cross-border securitizations with various tax jurisdictions. Given the complex nature of the transactions and the potential for innovation in the field, changes inevitably will occur in the regulations and enforcement patterns of various tax jurisdictions. However, the analyses outlined here for the various types of issues ought to remain useful tools for understanding and dealing with tax issues unique to cross-border securitizations.

51. *See* Treas. Reg. § 1.446-3(g)(4) (as amended in 1994).

52. *See id.* at § 1.446-3(g)(6), Ex. 3.

53. Significant penalties can be imposed, under Section 6662 of the Code, if inter-company pricing adjustments proposed by the IRS are upheld.