

RISK-SHIFTING WITHIN A MULTINATIONAL CORPORATION: THE INCOHERENCE OF THE U.S. TAX REGIME

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INTRODUCTION

As multinational corporations play a growing role in the global economy, sensible taxation of their cross-border transactions becomes increasingly important. However, U.S. taxation of risk-shifting within a single multinational corporation produces arbitrary results that are at odds with the underlying economic relationships. For example, a U.S. corporation with debt payable in a foreign currency might hedge its exchange rate risk through a currency swap with a foreign branch, which in turn could hedge the risk with a foreign third party.¹ Through these transactions, the U.S. corporation would successfully eliminate its currency risk and the transactions would net to zero. But despite the net zero economic impact of the debt and hedging, the transactions would have an important and often unpredictable effect on the corporation's U.S. tax liability.

This effect arises because the U.S. corporation's two third-party positions will have a different "source" for tax purposes, which in turn will affect the amount of foreign taxes that can be used to reduce U.S.

* Assistant Professor of Law, Harvard Law School. I am grateful for comments from Reuven Avi-Yonah, Charles T. Plambeck, H. David Rosenbloom, Reed Shuldiner, Jeff Sarnad, Alvin Warren, and the participants in the Harvard Law School Seminar on Current Tax Research. I would also like to thank Karen Johnson Shimp and Laurance Warco for their valuable research assistance.

¹ In a classic currency swap (which operates differently from an interest rate swap in that there is an exchange of principal at the beginning and end of the currency swap), Party A pays Party B X units of one currency, such as yen, in exchange for Y units of another currency, such as francs, on day one. During the period of the currency swap, Party A makes interim payments equal to a specified interest rate (fixed or floating) on Y units of francs, and Party B makes interim payments equal to a specified interest rate (fixed or floating) on X units of yen. At the end of the swap, the parties re-exchange the principal amounts. Currency swaps have generally been motivated by the observation that parties may have differing abilities to borrow in particular markets. The idea is to have each party borrow in its best (most advantageous) market and then find a swap partner who has borrowed in the currency sought. See generally JOHN C. HULL, *OPTIONS, FUTURES AND OTHER SECURITIES* 123-28 (1993).

tax liability. The foreign currency gain (or loss) on the U.S. corporation's debt will be U.S. source,² but the foreign currency loss (or gain) on the foreign branch's third-party swap will be foreign source.³ These will be the only two contracts recognized because the United States does not recognize a contract made by a U.S. company with its own foreign branch.⁴

The source of a U.S. corporation's income is critical in determining the amount of foreign tax credits that may be used to reduce U.S. income tax owed. The larger the portion of a taxpayer's income that is foreign source, the larger the amount of foreign tax credits that might be used. Thus, if the corporation's U.S. source income is increased (due to a foreign currency gain on the third-party debt) and foreign source income is correspondingly decreased (due to a parallel foreign currency loss on the foreign branch's third-party swap), then the taxpayer faces the possibility that it can use fewer foreign tax credits than it could in the absence of this economically net zero transaction. The reason is that the "foreign loss" reduces foreign source income, which otherwise might have carried additional foreign tax credits. Alternatively, if U.S. source income is decreased (due to a loss on the third-party debt) and foreign source income is increased (due to a gain on the branch's third-party swap), then this net zero transaction might enable the taxpayer to use more foreign tax credits than otherwise possible.

In either case, the amount of foreign tax credits that the taxpayer can use (and ultimately the tax owed to the United States) depends on a transaction which has no economic effect.⁵ Whether the taxpayer

² See I.R.C. § 988(a)(3)(A) (1996) (foreign currency gain or loss is sourced to the residence of the taxpayer or its relevant qualified business unit); I.R.C. § 988(c)(1)(B) (foreign currency transactions covered by the residence source rule include debt instruments and financial instruments).

³ See I.R.C. § 988(a)(3)(A); I.R.C. § 988(c)(1)(B).

⁴ See, e.g., Treas. Reg. § 1.446-3(c)(1)(i) (1994) (stating, in part, that "[a]n agreement between a taxpayer and a qualified business unit . . . is not a notional principal contract because a taxpayer cannot enter into a contract with itself.")

⁵ Because the tax problem created for U.S. companies engaging in interbranch transactions with their foreign branches turns on the use of foreign tax credits, the immediate severity of the problem depends on the taxpayer's foreign tax credit situation. If the taxpayer has excess limitation (i.e., sufficient foreign source income to use any available credits), an increase in foreign source income may not be significant. A decrease in foreign source income, however, might be harmful if the remaining foreign source income were no longer sufficient to use up the available foreign tax credits. If the taxpayer has excess credits, increasing or decreasing foreign source income might change the amount of foreign tax credits the taxpayer can use, depending on whether the credits and income relate to the same basket. See I.R.C. §§ 901(a), 904(d) (1996). Even if the current year impact on the use of foreign tax credits does not seem

or the U.S. fisc will be the winner or loser in any particular case is not predictable.⁶ Nonetheless, such a result should be unappealing to a tax system that is designed to accurately reflect the income of each taxpayer and that seeks to prevent taxes from being impacted by transactions that produce no net non-tax effect. Moreover, this result, which occurs in various cases of risk-shifting within a corporation, is both arbitrary and inconsistent with the U.S. tax treatment of risk-shifting within a multinational group of related corporations.⁷

This drastic divergence between economic substance and taxation derives from the U.S. tax treatment of internal risk-shifting. Unlike other major industrialized nations, the United States does not recognize risk-shifting within a multinational corporation, on the conceptual grounds that a party cannot contract with itself.⁸ Recognition of the interbranch contract between the home office and the foreign branch would result in four (instead of two) transaction legs to consider: (1) the home office's foreign currency debt, (2) the home office's position in the interbranch swap, (3) the foreign branch's position in the interbranch swap, and (4) the foreign branch's position in the third-party swap. If the interbranch swap were recognized for tax purposes, then the home office's gain (or loss) on its third-party debt would be U.S. source and would be offset by the home office's U.S. source loss (or gain) on the interbranch contract. Correspondingly, the branch's gain (or loss) on the interbranch contract and loss (or gain) on its third-party contract would both be foreign source and would offset each other.⁹ Recognition of the interbranch contract produces a tax result consistent with the underlying economic activity; a net zero transaction should not change a corporation's tax treatment and, with recognition of the interbranch contract, it does not.

significant for the above reasons, the impact may nevertheless be felt in prior or future tax years due to the credit carryover mechanism. See I.R.C. § 904(c); *infra* text accompanying notes 70-71.

⁶ There is no reason to believe that taxpayers have a special ability to accurately predict the movement of currency exchange rates, interest rates, or stock or commodity prices. Assuming efficient capital markets as a backdrop, the key is arm's length pricing of third party and related party contracts. See *infra* text accompanying notes 99-102.

⁷ See generally I.J.J. BURGERS, *TAXATION AND SUPERVISION OF BRANCHES OF INTERNATIONAL BANKS: A COMPARATIVE STUDY OF BANKS AND OTHER ENTERPRISES* (1991); Fred B. Brown, *Federal Income Taxation of U.S. Branches of Foreign Corporations: Separate Entity or Separate Rules?*, 49 TAX L. REV. 133 (1993); Yaron Z. Reich, *U.S. Federal Income Taxation of U.S. Branches of Foreign Banks: Selected Issues and Perspectives*, 2 FLA. TAX REV. 1 (1994); Leslie B. Samuels & Patricia A. Brown, *Observations on the Taxation of Global Securities Trading*, 45 TAX L. REV. 527 (1990).

⁸ See *supra* note 4.

⁹ See I.R.C. § 988(a)(3)(A) (1996).

This paper examines why U.S. taxation of risk-shifting within a single multinational corporation often creates a tax effect even though the transactions have no net economic impact and considers how tax rules can be developed that are more consistent with the taxpayer's economic activities. The depth of both the problem and the possible answers regarding the taxation of risk-shifting within a corporation can be better understood through a comparison with the more flexible tax treatment accorded risk-shifting within a multinational group of related corporations. The U.S. stance on risk-shifting within a single corporation is motivated by concerns that are not unique to inter-branch transactions but have been raised and addressed elsewhere. This observation suggests that steps can be taken to align U.S. taxation with the economic reality of the financial contracts that increasingly manage the cross-border risks of multinational corporations.

The analysis in this paper is divided into four parts. Part I explains how corporations use financial instruments¹⁰ to shift risk and further describes the arbitrary taxation of risk-shifting within a single corporation. Part II outlines the current tax treatment of three traditional risk-shifting transactions within a group of related corporations. These three scenarios form the basis of the comparative analysis of risk-shifting transactions that follows. Part III compares the taxation of risk-shifting within a single corporation (the branch cases) to the taxation of risk-shifting within a group of related corporations. Based on the comparison, Part III identifies key tax policy concerns and evaluates the conflict between the U.S. tax rules and those of other countries.¹¹ Finally, Part IV contemplates a series of proposals that would make the U.S. taxation of risk-shifting within the multinational corporation more coherent.

I. THE PROBLEM: TAXATION OF RISK-SHIFTING CONTRACTS WITHIN A CORPORATION

The availability of sophisticated risk analysis and risk management tools¹² has enabled many businesses to monitor and modify their risk

¹⁰ I will use the term financial instrument broadly, but I generally have in mind derivative financial instruments—those contracts, such as forwards, swaps and options, whose value depends on the price or rate movement of some underlying asset or index.

¹¹ This analysis involving financial instruments is pursued against the backdrop of the existing inconsistencies in the taxation of such instruments (e.g., the debt/equity distinction).

¹² Various statistics indicate the volume of derivatives business and its growth over time. For example, the worldwide volume of notional principal amount of derivatives outstanding as of the end of 1992 was \$12.1 trillion. GEN. ACCT. OFFICE, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM, GAO/GGD-94-133 (May 1994) (citing Eli M. Remolona, *The*

profiles through strategies of risk-shifting and hedging.¹³ Businesses increasingly rely on financial instruments to centralize and manage risk¹⁴ in a cost-effective manner.¹⁵ For a multinational corporation, this risk-shifting often may entail financial contracts within the corporation (interbranch contracts). For a group of related corporations, risk-shifting frequently is achieved through financial contracts between members of the group. Such contracts shift the risk from one member to another member of the group that can manage the risk more effectively—for example, by centralizing the group's risk of that type and hedging the net risk with a third party.¹⁶ An alternative risk-shifting strategy for a group of related corporations does not involve a financial contract between members. Instead, one member enters into a hedge with a third party on behalf of another member (risk pooling).

The U.S. tax rules governing risk-shifting contracts generally do not display the same flexibility as the business transactions themselves. In some cases, a group of related corporations that pool risks as if they were a single entity are taxed in accordance with the underlying economic relationships.¹⁷ Moreover, if the group chooses to use risk-shifting contracts between its members, the contracts are recognized in accordance with their economic role.¹⁸ Rarely, however, does the tax system recognize contractual risk-shifting within a single corporation (e.g., a contract between the home office and foreign branch of a

Recent Growth of Financial Derivative Markets, FED. RESERVE BANK OF N.Y. Q. REV. (New York: Winter 1992-93)). At the end of 1994, companies in Standard & Poor's 500 Index held derivatives totaling \$19 trillion. See *Study: S&P 500's Firms Held \$19 Trillion of Derivatives in '94*, THE Hous. CHRON., May 11, 1996, Bus. at 3. Trade in over-the-counter derivatives exceeded \$17 trillion in 1995. See Stephen Coplan, *Capital Briefs: OTC Derivatives Traded up Nearly 60% in '95*, AM. BANKER, July 11, 1996, at 2 (citing the International Swaps and Derivatives Association).

¹³ See, e.g., Paul K. Brooks, *Derivative Activities: Expanding Compliance Implications for the Bank Regulatory Manager*, 17 A.B.A. BANK COMPLIANCE 27 (May/June 1986) ("derivatives have become a key element in asset/liability and other financial risk management strategies of virtually all types of organizations"); Robert Brooks, *Derivatives Beyond the Rhetoric*, 42 RISK MGT. 37 (July 1995) (noting that "derivatives can help an organization clarify its risk exposures").

¹⁴ The scenarios under consideration here assume that the taxpayer is engaged in financial management as opposed to pure risk taking or speculating with respect to the financial instruments.

¹⁵ See, e.g., Brown, *supra* note 7, at 167-68; Charles T. Plambeck, *The Tax Implications of Global Trading*, 48 TAX NOTES 1143 (Aug. 27, 1990) [hereinafter Plambeck, *Taxation of Global Trading*]; Reich, *supra* note 7, at 16-17; Letter from Lawrence R. Uhlick, *International Bankers Present Position Paper on Cross-Border Interbranch Trading*, TAX CORRESPONDENCE, HIGHLIGHTS AND DOCUMENTS 51, 53 (Oct. 1, 1993).

¹⁶ Even in a consolidated group, related party risk-shifting can be useful. The related party transactions may be important in centralizing the risk management function, as explained in the examples that follow. See *infra* note 141 and text accompanying notes 141-42.

¹⁷ See *infra* text accompanying notes 150-57.

¹⁸ See *infra* text accompanying notes 150, 158-59.

corporation),¹⁹ despite actual and significant risk-shifting between the branches, and despite the fact that the branches may be treated independently for other legal purposes.²⁰ The tax law relies heavily on a party's legal status as a separate entity to identify the taxpayers and the relevant transactions.²¹ To the extent the tax law is currently willing to look beyond legal status, it is usually in one direction only—toward grouping legally separate entities together and treating them as one.

The question of transactions within a single corporation and within a group of related corporations is not unique to the use of financial instruments, but pervades much of the tax law, from transfer pricing to theories underlying the consolidated return provisions.²² The focus here, however, is limited to financial contracts and risk-shifting. The flexibility of financial instruments, their role in sophisticated financial management, and the fact that financial entities frequently operate internationally in branch form raise the stakes for the tax analysis of internal risk-shifting through financial contracts. Moreover, the rise of global trading has exacerbated the tension between tax law and business practice by increasing the cross-border business of banks and financial services entities which often use two or more branches in a transaction.²³ Ultimately, though, ideas developed in the context of

¹⁹ Although interbranch transactions are not generally recognized, an Advanced Pricing Agreement involving allocations from interbranch transactions was completed under the authority of a treaty. See *First APA Covering Cross-Border, Interbranch Bank Transactions Concluded*, 64 BANKING REP. (BNA) 524, 524-25 (Mar. 13, 1995).

²⁰ See, e.g., I.R.C. § 884 (1996) (branch profits tax imposes a 30% tax on dividend equivalent amounts "deemed" paid by the U.S. branch of a foreign corporation to its home office); Treas. Reg. § 1.988-1(a)(10)(ii) (1992) (recognizing interbranch foreign currency transactions under certain circumstances).

According to federal bank regulators, each bank branch must keep detailed records of the amounts due from and due to other branches or the home office. These records are subject to audit, and appear on various reports filed with the regulators by the branches. U.S. banks or branches with foreign affiliates must report their overseas obligations on a net due to/due from basis and must also file quarterly reports detailing their overseas exposure. Each branch is required to keep separate records supporting these figures. Thus, although the bank ultimately files consolidated records, each branch is treated separately for purposes of determining the amounts due to and from each other branch. (Based on 1996 conversation with an Office of the Comptroller of the Currency official describing the general policy and approach for bank branches); see also PAUL S. PILECKI ET AL., 9 BANKING L. 191.05 at 191-77, 191-79, 191-80 (1996) (discussing the scope of the authority of the Board of Governors of the Federal Reserve System regarding the examination of foreign bank branches, the obligation of the foreign bank branch to demonstrate that the head office can effectively monitor the "real performance and risks of the branch", and the Board's examination of the branch's stock of assets).

²¹ For example, incorporation as a separate legal entity under state or local law. David Bradford, *Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments*, 50 TAX L. REV. 731, 739-41 (1995).

²² See generally I.R.C. regulations under §§ 482, 1502 (1996).

²³ See, e.g., Samuels & Brown, *supra* note 7, at 529-30, 537 (first describing the developments

contractual risk-shifting may provide guidance for tax rules in other areas as well.

The first step, however, is to identify the problems: namely, the cases in which the taxation of risk-shifting fails to "accurately" or appropriately reflect the underlying activity. This requires understanding the use of financial instruments in risk-shifting.²⁴ Although the purpose of this paper is to think more comprehensively about the taxation of risk-shifting within a single corporation, it is necessary to begin with a discussion of specific examples and their current tax treatment in order to lay the foundation for the more conceptual analysis that follows.

Implicit in any claim that current law improperly taxes risk-shifting (to the taxpayer's detriment) is the view that the transactions involve valid business activities that should not be discouraged by the tax system, but instead should be taxed in accordance with the underlying economic transactions to minimize the impact of tax law on business behavior. With this in mind, the descriptions of the cases identify the business significance of the transactions.

A. *How Financial Instruments Are Used to Shift Risk*

This discussion serves as the baseline for the more complicated fact patterns that follow. The financial instrument used is a swap, either interest rate or currency. It was selected because it provides a clear example of a financial instrument used as a hedging transaction. Although the specific tax rules applicable to other financial instruments are different, their tax significance in this inquiry is the same.

that contributed to the growth of global securities trading and then explaining that the branch form is a common business structure for banking entities).

²⁴ The focus in this paper on financial instruments' central role in risk management differs from most literature on financial instruments, which tend to highlight their abuse potential. For example, the instruments often facilitate financial engineering that enables taxpayers to manipulate inconsistent tax rules. See, e.g., Alvin C. Warren, Jr., *Commentary - Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460, 491-92 (1993). A classic example was the tax rate arbitrage between periodic coupon bonds and zero coupon bonds prior to the enactment of effective original discount rules. See Bradford, *supra* note 21, at 739-741. Through such financial strategies, taxpayers can maximize their net after-tax position without affecting the underlying economic results. See, e.g., Reed Shuldin, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243, 335 (1992); Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 STAN. L. REV. 569, 573 (1994).

Although financial instruments are not the only transactions creating tension in the tax system, their inherent flexibility and their capacity to isolate and subdivide cash flows and facilitate risk-shifting magnifies their role. Thus, on the subject of financial instruments, the U.S. fisc generally is perceived to be the systematic loser. As a result, most tax analyses involving financial

1. Basic Financial Contract²⁵

Taxpayer (a U.S. corporation) and a domestic third party enter into an interest rate swap²⁶ (fixed rate of eleven percent for floating LIBOR²⁷ on a notional principal amount of four million dollars for five years).²⁸ The net periodic swap payments must be accrued currently.²⁹ Although there is no current guidance on the character of the periodic swap payments, commentators generally have assumed that in the case of an interest rate swap, the periodic payments are ordinary in nature.³⁰

The source of any gain or loss to Taxpayer on the swap will be U.S. source. Residence-based source rules traditionally have applied to payments under forwards, futures, and options contracts.³¹ These rules,

instruments principally concentrate on identifying and remedying the inconsistencies that permit taxpayer abuse, including the timing and character treatment of transactions. See, e.g., Bradford, *supra*, note 21; Noel B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 TAX L. REV. 725, 726 (1992); Mark P. Gergen, *The Effects of Price Volatility and Strategic Trading Under Realization, Expected Return and Retrospective Taxation*, 49 TAX L. REV. 209, 218 (1994).

²⁵ See, e.g., I.R.C. § 1234 (1996) (taxation of options); Treas. Reg. § 1.446-3 (1994) (taxation of notional principal contracts).

²⁶ For a more detailed description of swap transactions see, for example, S. HENDERSON & J. PRICE, CURRENCY AND INTEREST RATE SWAPS (1988); ANDREA S. KRAMER, FINANCIAL PRODUCTS: TAXATION, REGULATION, AND DESIGN 60.2, 1424-53 (1991).

²⁷ LIBOR is the London Interbank Offered Rate, the interest rate large international banks dealing in Eurodollars charge each other on short term loans.

²⁸ Thus, under the contract, Taxpayer agrees to pay annual amounts equal to 11% of \$4 million in exchange for annual payments equal to the current floating rate of LIBOR on \$4 million. Generally, Taxpayer and the counter-party will net their periodic payments so that only one actual payment will be made.

²⁹ See Treas. Reg. § 1.446-3(e)(2), (3). Regulations under I.R.C. § 446 provide very specific timing rules for a variety of notional principal contracts including caps, floors, collars, and swaps. These rules govern all taxpayers regardless of their regular method of accounting (e.g., cash or accrual). Special rules apply to dealers in financial instruments. See I.R.C. § 475 (1996). To the extent a dealer holds securities (defined to include notional principal contracts), any securities that constitute inventory must be included in inventory at fair market value. See *id.* § 475(a)(1). Any securities not considered inventory must be marked-to-market at year end. See *id.* § 475(a)(2). Other rules apply in the case of certain hedging transactions. See *id.* § 475(b)(1).

If the parties exchange swap premium or other non-periodic payments, the parties must recognize the payment over the life of the swap. See Treas. Reg. § 1.446-3(f)(2).

³⁰ See KRAMER, *supra* note 26, at 60.2(b)(i), 1428-29 (1991 & 1994 Supp.); Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1347 (1991); Edward D. Kleinbard & Suzanne F. Greenburg, *Business Hedges After Arkansas Best*, 43 TAX L. REV. 393, 426 (1988); Erika W. Nijenhuis, *Taxation of Notional Principal Contracts*, in TAXATION OF FINANCIAL INSTRUMENTS 3:38 (Reuven Avi-Yonah et al. eds., 1996); Christopher Dean Olander & Cynthia L. Spell, *Interest Rate Swaps: Status Under Federal Tax and Securities Law*, 45 MD. L. REV. 21, 41-42 (1986); Note, *Tax-Exempt Entities, Notional Principal Contracts, and the Unrelated Business Income Tax*, 105 HARV. L. REV. 1265, 1275-76 (1992).

³¹ See I.R.C. § 865(a), (j)(2) (1996).

which source gain or loss to the residence of the taxpayer, have been extended by regulation to cover other financial contracts, including swaps.³² In this example, Taxpayer is a U.S. corporation, thus any gain on the swap is U.S. source. Taxpayer's swap expense (e.g., any net periodic payment made by Taxpayer under the contract) is allocable to the class of swap income and therefore, in this case, is allocated to U.S. source income.³³

2. Hedging Transaction

In a variation on the above example, the same taxpayer (U.S. corporation) enters into the interest rate swap, not as a speculative transaction, but instead as a hedge of a debt instrument. Thus, assuming Taxpayer has a five year four million dollar debt instrument on which it is obligated to make interest payments based on LIBOR, the interest rate swap would eliminate the taxpayer's risk of interest rate movement³⁴ on this underlying debt.³⁵

Special hedge timing rules help prevent a tax mismatch between the swap (hedge) and the debt by requiring that a taxpayer "reasonably match" the timing of income, deduction, gain or loss from the hedge with that of the item hedged.³⁶ Recently promulgated capital asset rules

³² Treas. Reg. § 1.863-7(b)(i) provides that the source of income from a notional principal contract (a category of financial instruments), including an interest rate swap, "shall be determined by the residence of the taxpayer under Section 988(a)(3)(B)(i)," which looks to the tax home of an individual and in the case of a corporation, partnership or trust, its status under § 7701 of I.R.C. as foreign or domestic. Under certain circumstances, the source of income from a notional principal contract is determined based on the residence of the taxpayer's relevant business unit. See Treas. Reg. § 1.863-7(b)(2), (3) (1991).

³³ Treas. Reg. § 1.863-7(c) cross references Treas. Reg. § 1.863-1(c) for determination of taxable foreign and U.S. net income. The latter regulation prescribes treatment paralleling the allocation and apportionment of expenses and deductions to classes of gross income under Treas. Reg. § 1.861-8. In some cases, however, financial products that "alter the effective cost of borrowing" are treated as interest equivalents and their gains and losses are subject to special rules. See Treas. Reg. § 1.861-9T(b)(6) (1996).

³⁴ The risk that LIBOR will change is removed because Taxpayer receives LIBOR-based payments under the swap and uses them to satisfy its obligation to make LIBOR-based payments under the debt instrument. Taxpayer is left making a fixed rate payment to the swap party, which is not affected by movements in interest rates.

³⁵ Taxpayer, however, would not have eliminated all risk in the transaction. The risk of interest rate movement would be replaced with credit risk of the swap counter-party.

³⁶ See Treas. Reg. § 1.446-4(b) (1996). For example, if an item and its hedge are disposed of in the same taxable year, "taking realized gain or loss into account on both items in that taxable year may clearly reflect income." *Id.* Where the hedged item is a debt instrument, gain or loss from the hedge "must be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates." *Id.* § 1.446-4(c)(4). Thus, for example, a hedge of a debt that provides for interest to be paid at a fixed rate is generally accounted for using constant yield principles. *Id.*

clarify the character treatment of a hedging transaction.³⁷ An interest rate swap that is part of a qualified hedging transaction is not considered a capital asset, so it receives ordinary character treatment.³⁸

In this case, Taxpayer's swap cash flow functions as a cost of capital (i.e., as an "interest equivalent"), therefore special rules govern source.³⁹ Interest equivalents, which are expenses or losses incurred in transactions relating to the time value of money or hedging debt, must be allocated and apportioned in the same manner as interest.⁴⁰ Interest expense is allocated and apportioned across a taxpayer's domestic and foreign assets because money is fungible and thus, interest is considered attributable to all of a taxpayer's assets and activities.⁴¹ Any losses that Taxpayer suffers on this swap⁴² are allocated and apportioned, along with actual interest expense, across its U.S. and foreign assets.⁴³

Gains on the interest rate swap are not covered by the interest equivalent rules under I.R.C. §§ 861 and 864 and do not reduce interest expense subject to allocation and apportionment. Instead, any gain is sourced as it was in the prior example of a speculative transaction, to the residence of the taxpayer.⁴⁴ This regime results in a mismatch: gains and losses from the swap that hedges the debt are not sourced by the same rules. In this particular case, however, where the taxpayer (the U.S. corporation) has no foreign assets, the result is the same: all gains and losses on the hedge are sourced to the United States.

The tax rules recognize the potential problems from the sourcing mismatch of gain and loss and provide the taxpayer with an opportunity to unify the sourcing of gains and losses on certain financial contracts that are interest equivalents.⁴⁵ If a taxpayer uses a financial

³⁷ See *id.* § 1.1221-2(a)(1) (1996) (stating that the term "capital asset does not include property that is part of a hedging transaction"). Treas. Reg. § 1.1221-2(f)(2) provides that a transaction not properly identified as a hedging transaction does not qualify as a hedge, and its character is thus determined without reference to this section. To qualify, a hedge must be properly identified on the date the taxpayer enters into the hedge transaction. This requirement prevents the taxpayer from waiting to see if the transaction produces a gain or a loss before making the decision whether to identify as a hedge based on the particular tax treatment desired—usually capital asset treatment for gains, ordinary treatment for losses.

³⁸ See *id.* § 1.1221-2(a).

³⁹ See *id.* § 1.861-9T(b)(1) (1996).

⁴⁰ See *id.*

⁴¹ Pursuant to I.R.C. § 864(e)(2) and the regulations thereunder, Treas. Reg. § 1.861-9T(b) only applies to losses on interest equivalents.

⁴² See *infra* text accompanying notes 44–47 for a discussion on the treatment of a gain of the swap.

⁴³ See *infra* note 78.

⁴⁴ See Treas. Reg. § 1.863-7(b) (1991).

⁴⁵ Although the United States taxes the U.S. corporation on all of its income regardless of

instrument (such as an interest rate swap, cap, option or forward) to "alter the effective cost of borrowing,"⁴⁶ and both the hedge and the actual borrowing are in the same currency, any gains on the hedge reduce interest expense subject to apportionment.⁴⁷ As a result, Taxpayer's gains, as well as losses, on the financial instrument (in this example, the swap) are effectively apportioned.

B. *Current Tax Treatment of Risk-Shifting Within a Single Corporation*

Having illustrated the basic use and taxation of a swap, this section first examines why businesses operate through branches and why they engage in risk-shifting through interbranch contracts. Then, this section describes the use of a swap for risk-shifting within a single corporation and outlines the problems with its taxation under current law.

1. Taxpayer Reasons for Internal Risk-Shifting Through Interbranch Hedges

a. *Why Operate Through a Branch?*

A central premise of any discussion regarding the taxation of risk-shifting within a corporation is that the taxpayer's foreign operation is a branch. This raises the question of why a corporation would operate through a branch instead of through a subsidiary. Depending on the taxpayer's business, significant non-tax reasons may motivate the taxpayer's choice of the branch structure.

Banks frequently operate in foreign countries (i.e., not their place of incorporation) through branches.⁴⁸ This is in contrast to many other types of businesses, which typically operate in foreign countries through subsidiaries.⁴⁹ Regulators have observed that the preferred

where earned, source affects the use of foreign tax credits, and ultimately the total tax to be paid. See *supra* text accompanying notes 4-5; *infra* text accompanying notes 70-71.

⁴⁶ The U.S. corporation in the example is using the interest rate swap to "alter the effective cost of borrowing." The corporation has a borrowing (the \$4 million debt instrument) and it enters into the swap to effectively change its cost of borrowing (i.e. the interest owed) from a floating rate, LIBOR, to a fixed rate, 11%.

⁴⁷ Treas. Reg. § 1.861-9T(b)(6) (1996). The special rule for gain on interest equivalent hedges applies only if the taxpayer has satisfied the identification requirements specified and is not a financial services entity. See *id.* § 1.861-9T(b)(6)(iv). Regulations applying these rules to financial services entities have been reserved. *Id.* § 1.861-9T(b)(6)(v).

⁴⁸ See, e.g., MICHAEL GRUSON & RALPH REISNER, 1 REGULATION OF FOREIGN BANKS 10.01, 10-2 to 10-3 (2d ed. 1995) ("Foreign banks historically have engaged in the banking business in the United States through branches and agencies, rather than directly through subsidiaries . . .").

⁴⁹ Operating through a subsidiary can offer a number of benefits, including limited liability.

and usually most efficient manner of conducting international bank business is through foreign branches.⁵⁰ U.S. commercial banks and bank holding companies have more foreign branches than subsidiaries and they also have more of their foreign assets in branches than in subsidiaries.⁵¹ Similarly, branches account for most of the U.S. offices of foreign banks.⁵²

One primary reason that banks operate through branches involves the regulation of bank assets, capital structure and business activities.⁵³ For example, most countries limit a branch's ability to lend based on the bank's worldwide capital, not on some level imputed from the branch's size.⁵⁴ Also, although a parent can guarantee the loans of its subsidiaries, in practice, lenders frequently prefer to have direct access to all of the creditor bank's assets.⁵⁵ Thus, despite the appeal of using separate entities to benefit from limited liability, businesses, especially banks, are drawn to the use of branches to facilitate efficient capital deployment.

Certain tax problems arise, however, when banks structure their foreign activities through branches. Most significantly, bank branches frequently engage in intra-bank transactions on a cross-border basis—that is, transactions between a bank home office or branch located in

⁵⁰ See JAMES V. HOUP, BOARD OF GOVERNORS OF THE FED. RESERVE SYS. INTERNATIONAL TRENDS FOR U.S. BANKS AND BANKING MARKETS, STAFF STUDY, 2-4, 7, 10 (1988). This study, undertaken by the staff of the Board of Governors, was part of a broader effort by the staffs of the Board of Governors of the Federal Reserve System and of the Federal Reserve Banks to review a range of economic and financial subjects. See *id.* at 2. The paper, however, is stated to represent the view of the author and not necessarily agreement among the Board, the Banks or the staffs. See *id.* at i; see also Banque Indosuez et al., *Report on the Taxation of Global Trading of Certain Financial Instruments*, reprinted in 91 TAX NOTES INT'L 22-19 (May 29, 1991) (noting that "banks have traditionally utilized branch form to engage in international operations").

⁵¹ See HOUP, *supra* note 50, at 3 (Table 1, covering the period 1978-1987).

⁵² See *id.* at 25 (Table 17, covering the period 1978-1987). See also GEN. ACCT. OFFICE, FOREIGN BANKS - IMPLEMENTATION OF THE FOREIGN BANK SUPERVISION ENHANCEMENT ACT OF 1991, GAO/GGD-96-187 (Sept. 30, 1996) [hereinafter GAO REP'T, FOREIGN BANKS] (noting that "[b]ranches and agencies are the most common organizational forms—accounting for about 78 percent of foreign bank assets at the end of 1995," whereas "[f]oreign-owned U.S. banks [sic] subsidiaries held over 21 percent of foreign bank assets.").

⁵³ See, e.g., GRUSON & REISNER, *supra* note 48, at 10-2 (stating that "[t]he branch format, for example, may permit the most effective use of the foreign bank's capital."); PILECKI ET AL., *supra* note 20, at 191-10 (1996) (citing the report and study produced by the Treasury Department and the Board of Governors of the Federal Reserve System which concluded that foreign banks operate more efficiently through branches).

⁵⁴ See, e.g., GRUSON & REISNER, *supra* note 48, at 10-2 ("Foreign banks require substantial capital to establish a presence in the U.S. banking market. As a result, the U.S. branch may be able to consider capital historically accumulated by home country and other foreign operations so that it may not be subject to restrictive U.S. lending limitations.").

⁵⁵ See HOUP, *supra* note 50, at 2-3.

one country and a branch located in another country.⁵⁶ Interbranch transactions include not only loans, but also hedging transactions necessary for managing currency, interest rate and other risks. As noted below, in some cases, such as foreign currency hedging, the branch may be the best choice for hedging because it is one of the primary dealers in the currency and can most effectively transfer the risk to third parties.⁵⁷

b. *Why Transact with a Branch?*

The next question raised by the analysis of risk-shifting within a single multinational corporation is why contract with the foreign branch. If the home office has a third-party position it must hedge, the foreign branch may be in the best position to execute the hedge. For example, it may be operating in the primary market for that risk (e.g., the main market for that currency) and may have existing relations and contracts with the local participants. Often, the branch may be a dealer with respect to such contracts and may represent a cost effective counter-party.

An interbranch contract, however, is not necessary to take advantage of the foreign branch's special market position. The branch could execute a third-party swap without entering into an interbranch transaction with the home office. Taxpayers, however, frequently do use interbranch transactions. A primary business reason for the actual interbranch contract is that the record of interbranch transactions helps identify and measure the value provided to the corporation by each separate branch/business unit. By entering into the interbranch contract, as opposed to having the branch execute only the third-party contract, the home office and branch can show their respective values to the organization through a fair market value interbranch contract.⁵⁸

⁵⁶ See, e.g., GRUSON & REISNER, *supra* note 48, at 10-9 (noting that a common structure for banks engaging in financial instrument transactions and global trading involves each branch or office hedging "its own position by entering into interbranch financial product transactions with other offices.")

⁵⁷ See *infra* Part I.B.1.b. Also, for example, reducing the number of third-party hedges executed can reduce transaction costs. See *infra* note 141 for discussion of the use of related party hedging transactions in the consolidated group context.

⁵⁸ See, e.g., Robert A. Katcher & Jean A. Pawlow, *Interbranch Banking Regs Create Burden*, THE NAT'L L.J. 25 (June 1, 1992). They note in a discussion of the management strategy of banks that: the traditional tax rules apparently ignore the fact that the branches of a home-office bank, like divisions in a large corporation, normally operate as independent profit centers. A branch must show management how its operation contributes to the overall profit of the bank. The branch's budget and salaries of its employees often depend on a showing that the branch made a profit. Presumably, this acts as

Tax law also provides a reason for actual transactions and their recognition. As described in the examples that follow, recognition of interbranch contracts (and thus the recognition of risk-shifting within the corporation) reduces potential tax distortion. The use of actual interbranch contracts facilitates the tax system's recognition and reliance on the contracts. Many other countries⁵⁹ acknowledge the role of contractual risk-shifting within a single multinational corporation, and taxpayers that engage in the actual transactions may be taxed by such countries in a manner more consistent with the underlying economic activity.⁶⁰ Thus, the needs of business management and the desire for more economic taxation lead taxpayers to shift risk internally and use interbranch contracts.

2. Taxation of Risk-Shifting Within a Corporation Through Interbranch Contracts

a. *U.S. Corporation with Foreign Branch*

The mere existence of a branch is not a tax problem. If the financial contracts are entered into with a third party, the applicable tax rules are those described above. Thus, if Taxpayer, a U.S. corporation with a foreign branch, enters into an interest rate swap with a third party, the tax treatment would mirror that of the baseline U.S. corporation with no related parties.⁶¹ Similarly, if Taxpayer enters into a

a check on interbranch interest charges, to ensure that the transactions will be at market rates.

Id. Although the business incentives created by interbranch competition do not negate the need for a statutory backup against pricing abuses, the incentives are helpful in understanding the relationship of the parts of the entity. They also suggest that the entity's internal books may accurately reflect each part's contribution.

⁵⁹ See *infra* text accompanying notes 117–19, 191–200.

⁶⁰ As discussed *infra* text accompanying notes 85–102, the potential for very distortive tax results is possible, particularly in the case of foreign corporations with U.S. branches. To the extent that the impact of the current tax rules is negative and/or unpredictable (because it depends on whether a particular contract position is a winner or loser) taxpayers may either bear this burden, or not engage in the transaction at all, which may not be desirable from a monitoring, regulatory, accounting or business efficiency perspective. See *supra* text accompanying notes 48–55.

⁶¹ See *supra* text accompanying notes 26–33. Note that if the swap is considered a contract of a foreign branch that constitutes a “business unit,” swap income might be sourced to the residence of the branch (here, a foreign location) as opposed to the residence of the corporation (i.e., its place of incorporation, here, the United States). See Treas. Reg. § 1.863–7(b)(2), (3) (1991). In some cases, this can produce a split hedge (the hedge in one branch, the hedged item in another), a situation related to the branch examples and the consolidated group hedging issue discussed later.

third-party interest rate swap to hedge its interest rate risk by converting its floating rate (LIBOR) debt to fixed rate debt, the tax treatment would be the same as for the baseline U.S. corporation hedging with a third party. Because the hedge would be an interest equivalent, any losses on the swap would be subject to the allocation and apportionment rules, as would swap gains, assuming the swap is qualified and identified.⁶² Taxpayer in this case has at least some foreign assets (the branch assets), so a portion of any swap expense would be allocated to foreign source income.⁶³

If, however, Taxpayer (more specifically, the home office) seeks to hedge its floating rate debt by entering into a swap with its foreign branch, which in turn hedges the risk with a local third party in the branch's country, the analysis changes.⁶⁴ U.S. tax law, as a general rule, will not recognize contractual risk-shifting within a single corporation because it does not acknowledge interbranch transactions.⁶⁵ Financial contracts do not exist between branches: an "agreement between a taxpayer and a qualified business unit . . . or among qualified business units of the same taxpayer is not a notional principal contract [a general category of financial contract] because a taxpayer cannot enter into a contract with itself."⁶⁶

Economically, the taxpayer has hedged the interest rate risk, both as separate business units (so that the home office and the branch standing alone are hedged for the risk), and as an overall unit. For tax purposes, however, only the home office's debt and the foreign branch's third-party swap are recognized. The home office and the branch positions in the interbranch swap are ignored. Nonetheless, the taxpayer is hedged from a total taxable income perspective because

⁶² See Treas. Reg. § 1.861-9T(b)(6) (1996); *supra* text accompanying notes 39-47.

⁶³ See Treas. Reg. § 1.861-9T(g), (h).

⁶⁴ In another very common example, interbranch hedging would be used to shift foreign currency risk as described in the example in the introduction. Often, a branch office may be the best counter party. For example, if a branch office operates in the franc and the home office operates in the dollar, then if the home office has any franc risk to shift, it may be most efficient to accomplish that shift through the branch office if it is one of the major traders in the franc or is better placed in the market than the home office.

⁶⁵ See, e.g., Treas. Reg. § 1.863-7(a)(1) (1991) (an agreement between a taxpayer and a qualified business unit ("QBU") of the taxpayer is not a notional principal contract because a taxpayer cannot enter into such a contract with itself). An exception that will be considered later appears in the foreign currency regulations and in certain cases provides for recognition of interbranch transactions. See *id.* § 1.988-2(a)(10)(ii) (1993).

⁶⁶ *Id.* § 1.446-3(c)(1)(i) (1994) (defining a notional principal contract as a "financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts").

the United States taxes its domestic corporations on a worldwide basis.⁶⁷ Moreover, if the taxpayer identifies the positions in advance, the timing and character treatment of the two "recognized" items will be matched.⁶⁸ As a result, the entity's economic income of zero translates into taxable income of zero, even though two of the four total transaction legs are not recognized.⁶⁹ Taxable income, however, is not the end of the inquiry. The true bottom line is income tax paid to the United States, which depends not only on taxable income but also on the tax credits available to reduce the tax owed.

Although in terms of income and loss the interbranch hedging transactions of a U.S. corporation may net to zero, a potentially significant sourcing distortion can be created by the failure to recognize the interbranch contract. The distortion may impact the actual amount of tax paid to the United States by affecting the foreign tax credit calculation. This issue underlays the problem case introduced at the beginning of the paper regarding the taxation of risk-shifting between a U.S. corporation's home office and its foreign branch through a currency swap.⁷⁰ Pursuant to the statutory formula limiting the availability of foreign tax credits, the larger the portion of a taxpayer's total income that is foreign source, the larger the maximum amount of foreign tax credits that can be used to reduce U.S. income tax.⁷¹ As a result, U.S. taxpayers typically have strong incentives to classify more of their income as foreign source, rather than domestic source, and, correspondingly, to say that more of their deductions should be used to reduce U.S. income, as opposed to foreign source income.

As described earlier, the U.S. tax treatment of risk-shifting within a multinational corporation creates significant sourcing distortions for a U.S. corporation hedging a currency risk with its foreign branch.⁷² Because of the unique allocation rules applicable to interest expense, however, the source distortion from not recognizing interbranch contracts is minimized in the case of an interest rate hedge. In the present example of the U.S. corporation entering into an interest rate swap

⁶⁷ That is, changes in LIBOR no longer directly impact taxpayer's taxable income line (assuming these were the only transactions).

⁶⁸ See Treas. Reg. § 1.1221-2(c) (1996).

⁶⁹ The four legs are: (1) the home office's third-party debt, (2) the home office's swap position with the foreign branch, (3) the foreign branch's swap position with the home office, and (4) the foreign branch's swap position with the third party.

⁷⁰ See *supra* text accompanying note 1.

⁷¹ See I.R.C. § 904(a) (1996).

⁷² See *supra* text accompanying notes 1-6.

with its foreign branch, gain and loss are split between U.S. and foreign sources. Interest expense on the home office debt is allocated across the taxpayer's entire domestic and foreign assets, reducing both U.S. source and foreign source income.⁷³ If the third-party swap (the only leg, other than the debt, to be recognized) is not identified as a cost of borrowing,⁷⁴ then any gain⁷⁵ on the swap is sourced to Taxpayer's residence⁷⁶ (or residence of the relevant business unit—here, the foreign branch⁷⁷) that is, foreign source, so that the hedge fails to produce a net zero impact in terms of source.⁷⁸ If the swap is identified properly, any gain on the third-party swap reduces interest expense subject to allocation and apportionment.⁷⁹

The result, therefore, is that to the extent the third-party swap is identified as a cost of borrowing under the interest allocation rules,⁸⁰ it should not make a difference that the interbranch swap is not recognized because both the debt interest expense and the swap gain or loss are effectively allocated and apportioned, producing a net zero impact in terms of source.⁸¹ Alternatively, to the extent the third-party swap is not identified, loss is treated as it would be in any case in which swap payments function as interest equivalents (i.e., it is allocated and

⁷³ See Treas. Reg. § 1.861-9T(b)(1) (1996).

⁷⁴ See *id.* § 1.861-9T(b)(6) (a product that can potentially alter taxpayer's effective cost of borrowing with respect to an actual liability of the taxpayer).

⁷⁵ If the swap has gain (because the floating rate, LIBOR, increases), then correspondingly more interest will be owed on the debt for that period.

⁷⁶ If the swap has not been identified as a cost of borrowing, then gain on the swap does not reduce the taxpayer's total interest expense that is subject to apportionment. See Treas. Reg. § 1.861-9T(b)(6)(iv)(B). In that case, the background rules for sourcing gain apply. See *supra* text accompanying notes 31-32.

⁷⁷ Notional principal contract income will be sourced to the residence of the branch (or, more specifically, the QBU as defined in § 989(a) of the I.R.C. if:

- (1) the taxpayer's residence is the United States;
- (2) the QBU's residence, as determined under I.R.C. § 988(a)(3)(B)(ii), is outside the United States;
- (3) the QBU is engaged in a trade or business in the country in which it is a resident; and

(4) the notional principal contract is properly reflected on the books of the QBU. Treas. Reg. § 1.863-7(b)(2) (1991). See *supra* note 32.

⁷⁸ Any loss is allocated and apportioned like interest expense, thus reducing U.S. and foreign source income. See Treas. Reg. § 1.861-9T(b)(2). If there is loss on the third-party swap due to a decline in floating interest rate, less interest will be owed on the debt during that period.

⁷⁹ See *id.* § 1.861-9T(b)(6).

⁸⁰ If Taxpayer had used an interbranch swap as well, the third-party swap might not be identified as a cost of borrowing because that would be the role of the interbranch transaction.

⁸¹ Technically, swap loss is allocated and apportioned, and swap gain reduces interest expenses subject to allocation and apportionment. See Treas. Reg. § 1.861-9T(b).

apportioned across taxpayer's domestic and foreign assets),⁸² and gain is foreign source, resulting in a sourcing mismatch.⁸³

This scenario, in which recognition or nonrecognition of inter-branch contracts plays a minimal role, is limited to cases involving a U.S. corporation's interest and interest equivalents because of the special treatment accorded them. The serious source problem for domestic corporations concerns a taxpayer, like the one in the introductory case of the currency swap, whose home office has a third-party contract on which gain or loss is sourced by residence and is not subject to apportionment.⁸⁴ In that case, the gains and losses from the underlying position and the hedge contract will not offset for source purposes, as demonstrated by the introductory case.

b. *Foreign Corporation with U.S. Branch*

The United States' nonrecognition of contractual risk-shifting within a single multinational corporation produces tax distortions for U.S. branches of foreign corporations that can be more significant than those experienced by U.S. corporations. The reason is that unlike U.S. corporations, foreign corporations are taxed almost exclusively on their U.S. source income, so a general netting of income and loss cannot be relied on to eliminate certain distortions.⁸⁵

In this example, Taxpayer is a foreign corporation with a U.S. branch office. The branch enters into a Swiss franc interest rate swap with a third party.⁸⁶ Taxpayer may view the branch substantially as a

⁸² See I.R.C. § 864(e)(2) (1996); Treas. Reg. § 1.861-9T(b).

⁸³ Initially, it may appear advantageous not to identify here because a loss is treated no differently than if it had been identified, and any gain would be foreign source income, potentially increasing Taxpayer's ability to use foreign tax credits. The rules limiting foreign tax credits, however, would probably classify this swap income in the "passive income basket," making it virtually useless in increasing Taxpayer's use of foreign tax credits. Taxpayer, therefore, might identify, and the impact on sourcing caused by the U.S. treatment of internal risk-shifting would be muted. See Treas. Reg. § 1.904-4(b) (1994).

⁸⁴ The example used in the text involves foreign currency. Many other items, however, are sourced on a residence basis. The residence of the taxpayer rule governs source of gain on notional principal contracts. See *id.* § 1.863-7(b)(1) (1991). Losses are allocated to the related class of gross income. See *id.* §§ 1.863-7(e), 1.863-1(c) (1996), 1.861-8 (1995); see also I.R.C. § 865(a) (1996) (providing that gain from the sale of personal property is sourced to the residence of the seller, unless covered by the enumerated exceptions).

⁸⁵ See generally I.R.C. § 881(a) (1996) (taxing foreign corporations on certain U.S. source income not effectively connected with a U.S. trade or business); § 882(a) (1996) (taxing foreign corporations on income effectively connected with a U.S. trade or business); § 864(c)(1)-(4) (defining effectively connected income to cover most U.S. source income, and very limited non-U.S. source income).

⁸⁶ Thus, the branch might agree to pay the third party the equivalent of a specified floating

separate entity, particularly if Taxpayer is a bank. Assuming Taxpayer is a bank, then for various banking and regulatory purposes, the branch will be required to balance its books independent of the home office.⁸⁷ Taxpayer will seek to have its U.S. branch balanced (hedged) for U.S. tax purposes as well, because the United States taxes only the branch, not the entire entity. The branch may decide to hedge its third-party swap by entering into an offsetting swap with the home office because, as observed earlier, the home office may be the best or most efficient counter-party for the Swiss franc contract. As a result of the swap, the branch's books are hedged economically for the Swiss franc interest rate risk.⁸⁸ The home office will then hedge the risk with a third party. For example, if the U.S. branch earns \$100 on its third-party position and pays \$100 on the offsetting swap with the home office, then the home office will receive \$100 on the interbranch swap and pay out \$100 to a third party in the home country.⁸⁹ Not only is the entire corporation hedged for the risk, but the branch and the home office are also hedged when considered independently. This is important to the extent the home office or branch is taxed on a stand-alone basis, which is the U.S. treatment of the branch.

With respect to U.S. branches of foreign entities, the United States taxes the branch on income that is "effectively connected" with the U.S. branch's business activities.⁹⁰ Thus, it is necessary to identify income and expenses properly associated with the U.S. branch.⁹¹ The determination of whether income is considered effectively connected with the U.S. branch's business differs depending on the type of income. Capital gains, as well as "FDAP" gains,⁹² are effectively connected

rate on *X* Swiss francs in return for receiving the equivalent of a specified fixed rate (e.g., nine percent) on *X* Swiss francs. This contract is an I.R.C. § 988 foreign currency contract for the branch, assuming the branch's functional currency is the dollar. *See* Treas. Reg. §§ 1.988-1(a)(6) Ex. 10 (1992); 1.985-1(b)(3) (1994). In that case, the gain or loss earned by the branch on the contract would be sourced to the residence of the branch, the United States. *See* I.R.C. § 988 (a)(3)(A) (1996).

⁸⁷ *See supra* note 20.

⁸⁸ The branch's swap with the home office, under which the branch would agree to pay the home office the equivalent of a specified fixed rate of interest on *X* Swiss francs in return for receiving a specified floating rate on *X* Swiss francs, would be an I.R.C. § 988 foreign currency contract for the branch. Thus, any branch gain or loss on the contract would be U.S. source. *See supra* note 2.

⁸⁹ Profit margins are omitted for simplicity. The gain and loss is expressed in dollars because the branch would ultimately be reporting in dollars for U.S. tax purposes.

⁹⁰ *See* I.R.C. § 882(a).

⁹¹ *See id.* §§ 861, 862, 864 (1996).

⁹² Fixed, determinable, annual or periodic income such as interest, dividends and rents. *See id.* §§ 871(a)(1); 881 (1996).

if they satisfy either the "asset use"⁹³ or "business activities"⁹⁴ test.⁹⁵ All other U.S. source income (i.e., income that is not capital gains or FDAP) is considered effectively connected with the branch's U.S. business.⁹⁶ Deductions are permitted to the extent they are connected with income that is effectively connected with the conduct of the branch's business.⁹⁷ The U.S. branch's gain or loss on its two swap positions would be U.S. source items effectively connected with the U.S. trade or business.

Under the facts described above, if the transaction between the U.S. branch and its home office (or other foreign branch) is not recognized, then the net taxable income properly associated with the activities of the U.S. branch will not be accurately determined. Given that the home office's third-party swap usually is not attributed to the U.S. branch or recognized for tax purposes by the United States, the U.S. branch will be taxed as if its third-party position was the only contract. Thus, the United States will tax the U.S. branch on \$100 of income despite the net zero impact of the hedged item and inter-branch hedge.⁹⁸ The direction of this inaccurate result is not predictable and could whipsaw either the taxpayer or the government.⁹⁹ In the hypothetical, the U.S. branch had gain of \$100 on its third-party position and would be inappropriately taxed by the United States on that gain. The branch, however, could just as easily have suffered a loss on that contract and thus obtained an unwarranted reduction in U.S. taxes.

The serious ramifications of the current tax rules for risk-shifting within a single multinational corporation became publicly apparent in November 1992, when Westpac Banking Corporation, a major Australian bank, was forced to cut its forecasted final dividend by fifty percent due to an unanticipated U.S. tax charge of \$115 million.¹⁰⁰ The tax charge was related to currency and interest rate swaps between West-

⁹³ Satisfying the asset use test depends on whether the income, gain, or loss derives from assets used in the foreign taxpayer's U.S. business. See *id.* § 864(c)(2)(A).

⁹⁴ Satisfying the business activities test depends on whether the activities of the foreign taxpayer in the U.S. business were a material factor in the realization of the income, gain, or loss. See *id.* § 864(c)(2)(B).

⁹⁵ See I.R.C. § 864(c)(2).

⁹⁶ See *id.* § 864(c)(3).

⁹⁷ See *id.* § 873(a) (1996).

⁹⁸ See generally Brown, *supra* note 7, at 167-68; Plambeck, *Taxation of Global Trading*, *supra* note 15, at 1154.

⁹⁹ See *supra* text accompanying notes 5-6.

¹⁰⁰ See Bruce Jacques, *Westpac Halves Payout Forecast in Prospectus*, FIN. TIMES, Nov. 6, 1992, at 30.

pac's New York branch and its non-U.S. branches during 1991 and 1992.¹⁰¹ Westpac had to pay U.S. taxes on swap profits of the U.S. branch without being able to offset the gain with the matching losses.¹⁰²

c. *Domestic Interbranch Risk-Shifting*

In the description of U.S. corporations with only domestic activities, the issue of different "branches" located within the United States was not considered. The reason is that in most cases the business decision to identify separate U.S. branches of a U.S. corporation (perhaps geographically-based or activity-based divisions) has no impact on taxes. The taxpayer is taxed currently by the United States on all gain or loss and, if all activities are domestic, then all income is domestic source.

Even in an all domestic context, however, the business use of branches or, more commonly, divisions, may be relevant, and the failure to recognize their use for tax purposes may result in tax distortions. The failure to recognize interbranch or inter-division transactions (even entirely domestic transactions) could produce a mismatch in the timing of taxable income or loss, despite the fact that the taxpayer has fully hedged that risk economically.¹⁰³

An example arises in the case of a U.S. bank which operates two divisions, a treasury division and a dealer division, each with separate and independent books and records.¹⁰⁴ The former makes business investments and operates on an accrual basis. The latter, which buys and sells financial instruments with customers, is required to use mark-to-market accounting.¹⁰⁵ The bank's treasury function may often seek to hedge risk, such as interest rate exposure, with the dealer division, which in turn hedges its net risk with a third party. The dealer division

¹⁰¹ See Robert Rice, *Business and the Law: Double Trouble - Global Financial Trading Groups Must Guard Against Inadvertently Paying Tax Twice Over*, FIN. TIMES, Dec. 1, 1992, at 10.

¹⁰² See *id.*

¹⁰³ See generally *Banks Ask for Change in Hedging Regs.* (Aug. 9, 1994), 94 TAX NOTES TODAY 167-11 (Aug. 25, 1994) [hereinafter *Banks Ask for Change*]. The banks urged the Treasury to apply the "separate entity election" approach from the consolidated group rules to separate divisions of a single entity to prevent timing mismatches on hedging transactions. See *id.* The banks sought to treat a single taxpayer with multiple activities, including some dealer activities subject to the mark-to-market regime, as if the dealer activity were conducted by a separate corporation in a consolidated group that had elected separate entity treatment. See *id.*

¹⁰⁴ See *id.* at Exhibit B; see also Letter from Lawrence R. Uhlick, *International Bankers Present Position Paper on Cross-Border Interbranch Trading*, HIGHLIGHTS AND DOCUMENTS 51, 53 (Oct. 1, 1993).

¹⁰⁵ See I.R.C. § 475 (1996).

serves as an "intermediary" in hedging risk for reasons of efficiency and economies of scale.

If the treasury division engages in a hedge with the dealer division, Taxpayer could have a minimum of four transaction legs: (1) treasury's position with a third party that creates interest rate risk (e.g., a debt instrument); (2) treasury's swap with the dealer division that shifts the interest rate risk to the dealer; (3) dealer's corresponding position in the interest rate swap with treasury, and (4) dealer's swap with a third party that hedges dealer's net exposure to interest rate risk (which may be due to a combination of transactions, including the swap with treasury). The interdivisional swap (i.e., legs 2 and 3) effectively identifies the gain or loss on that portion of the dealer division's aggregate third-party positions that hedge the treasury division's risk.¹⁰⁶ For the hedge to be effective for tax purposes, the treasury division's risk must be matched with the hedge to eliminate any timing or character discrepancies. The goal of the inter-division hedge is to accomplish this by recognizing leg 2 as the hedge of the treasury division's third-party debt (leg 1) and matching the timing of both positions pursuant to the hedging rules under I.R.C. § 446.¹⁰⁷

If, however, the inter-division hedge is not recognized, the only "existing" transactions are leg 1, an accrual transaction, and leg 4, a mark-to-market transaction. Often leg 4 may not be a full hedge of leg 1 because leg 4 is a hedge of the dealer division's net interest rate exposure. For example, the dealer's net hedge in leg 4 may be hedging only half of the risk of leg 1 because the dealer has other outstanding positions that economically hedge the other half of that risk. In that case, the taxpayer likely cannot identify a specific outstanding third-party position of the dealer that is part of the effective hedge for the treasury division risk. The reason is that there is no such transaction. Rather, it is the net effect of the dealer division's positions that creates part of the hedge. Without a specific transaction to identify, the taxpayer fails to identify any hedge, much less one that is contemporaneously identified.¹⁰⁸

Assuming at least a portion of the treasury division's economic hedge through the dealer division's position is not identified or qualified for tax hedging treatment, then a timing mismatch occurs. Treasury division's third-party debt (leg 1) is taxed on an accrual basis, but any portion of the hedge effectuated by the dealer's aggregate third-party

¹⁰⁶ See *Banks Ask for Change*, *supra* note 103, at Exhibit B.

¹⁰⁷ Treas. Reg. § 1.446-4(b) (1996).

¹⁰⁸ See *id.* § 1.446-4(d)(1), (2).

positions¹⁰⁹ is marked-to-market.¹¹⁰ Although the risk has been hedged (that is, the combination of the hedged item and the hedge are economically net zero transactions), the gain may be realized in one year and the offsetting loss taken into account in a later year, producing a timing mismatch that distorts taxable income. Therefore, recognition of the inter-division hedging contract may be necessary to achieve the accurate reflection of income contemplated by the hedging rules.¹¹¹

3. Assessment of the Current Rules on Internal Risk-Shifting

From the perspective of the U.S. tax system, which relies substantially on legal status to identify taxpayers, a corporation generally represents the smallest divisible taxable unit of an incorporated entity. Transactions at a level smaller than that (e.g., between branches of a corporation, or between the home office and a branch) usually are not recognized for U.S. tax purposes.¹¹² Therefore, the swap transaction between the U.S. home office of a bank and its foreign branch, or a foreign bank home office and its U.S. branch, is not recognized and has no tax effect.

This nonrecognition of risk-shifting within a corporation conflicts with: (1) regulatory treatment,¹¹³ (2) the economic¹¹⁴ nature of the

¹⁰⁹ This could be, for example, the difference between leg 3 and leg 4 if the dealer division did not need to enter into a third-party interest rate swap completely offsetting leg 3 because the dealer division already had an aggregate third-party position that achieved a portion of that offset.

¹¹⁰ See I.R.C. § 475.

¹¹¹ See, e.g., *Banks Ask for Change*, *supra* note 103 (arguing that the principles inherent in the proposed hedging regulations for consolidated groups, as well as the legislative history of I.R.C. § 475, support recognition of each interdivisional contract). See also 61 Fed. Reg. 517, 1996-12 I.R.B. 4 (1996) (preamble to the final consolidated group hedging regulations under I.R.C. §§ 446 and 1221, illustrating the matching concept); 59 Fed. Reg. 36,356, 36,358 (1994) (preamble to the final § 446 of the I.R.C. hedging regulations explains that the regulations require a clear reflection of income through the matching of income, deduction, gain, or loss from a hedge, with that of the hedged item).

¹¹² See, e.g., *supra* note 4.

¹¹³ Banking regulations often guide banks towards the branch form, but simultaneously require the branch to maintain separate records as a way to assess the independent status and stability of the individual branches.

¹¹⁴ If the transactions have net zero economic effect but, under the current rules, produce a tax impact, the tax rules are in conflict with the underlying economics. Specifically, the tax law in such a case impacts business behavior. If the baseline ideal for tax rules is that they be neutral in terms of impacting taxpayer behavior, then the current rules, which allow a net zero transaction to produce a tax impact (either increasing or decreasing taxes), would clearly fail to meet the ideal. To move toward a tax system that is "invisible" except for rates and source, the tax rules for interbranch transactions and internal risk-shifting must be revisited. The mismatches produced by the current rules in the case of a U.S. corporation with a foreign branch, and even more significantly in the case of a foreign corporation with a U.S. branch, are problematic for

transaction,¹¹⁵ and (3) the tax treatment generally accorded interbranch (especially bank) transactions by other countries. These points are in fact related. Most Organization for Economic Cooperation and Development ("OECD") countries would recognize a bank interbranch hedging transaction because of the regulatory regime governing banks, as well as the particular business functions of a bank.¹¹⁶ Many countries recognize interbranch transactions generally, including Denmark, Canada, Germany, Italy, Sweden, the Netherlands, Norway (if the transaction is at arm's length and for good reason), Switzerland and Australia (for foreign bank branches).¹¹⁷ For example, the "U.K. will treat branches of overseas corporations as though they are independent from their head office and other branches."¹¹⁸ Besides the United States, a few countries do not recognize interbranch transactions—Belgium, Finland, the Republic of China and New Zealand.¹¹⁹ The difference between the current U.S. approach to taxing interbranch transactions and that of many other countries is considered further in Part III.¹²⁰

The tax consequences of the United States' failure to recognize a U.S. corporation's interbranch transactions may be minor compared to the impact of non-recognition on foreign corporations, particularly financial institutions, with U.S. branches.¹²¹ Theoretically, these difficulties could be solved if the taxpayers used subsidiary structures instead of branches. Given, however, that independent regulatory and business standards may favor the branch form of organization, the tax system should not be content to resolve problems of interbranch transactions and risk-shifting within a corporation by pointing out the taxpayer "option" of incorporating the branch.¹²²

the very reason that they will distort taxpayer behavior. There is no evidence that the current rules were part of a policy determination to use the branch tax rules to impact hedging and branch operations in the way in which they do.

¹¹⁵ The current regime appears to "ignore the fact that the branches of a home office bank, like divisions in a large corporation, normally operate as independent profit centers." Katcher & Pawlow, *supra* note 58, at 25.

¹¹⁶ See, e.g., Stephen Brecher, *The IRS - Out of Step with Its Trading Partners*, 22 INT'L TAX J. 20, 20 (Summer 1996) ("Unlike many of its OECD trading partners, the U.S. does not generally recognize transactions between branches of the same entity for tax purposes."). See *infra* text accompanying notes 191-200.

¹¹⁷ See Charles T. Plambeck et al., *The General Report, TAX ASPECTS OF DERIVATIVE FINANCIAL INSTRUMENTS-GENERAL REPORT*, CAHIERS DE DROIT FISCAL INTERNATIONAL vol. LXXXb 653, 687 & n.92 (1995). See generally *Banque Indosuez*, *supra* note 50.

¹¹⁸ *Banque Indosuez*, *supra* note 50, at Appendix B.

¹¹⁹ See Plambeck, *supra* note 117, at 687 & n.93.

¹²⁰ See *infra* text accompanying notes 191-200.

¹²¹ See *supra* text accompanying note 85.

¹²² As another alternative, corporations that have separate branches and want to enter into interbranch transactions could run the interbranch contract through a related subsidiary. For

II. CURRENT TAX TREATMENT OF RISK-SHIFTING WITHIN A GROUP OF RELATED CORPORATIONS

Having described the problems with the current tax treatment of interbranch transactions and risk-shifting within a single corporation, the next step is to outline the somewhat different tax treatment accorded hedging transactions between legally separate but related entities. This Part reviews three basic cases in which related corporations use financial instruments to hedge risk: (1) a U.S. corporation with a domestic subsidiary; (2) a U.S. corporation with a foreign subsidiary; and (3) a foreign corporation with a U.S. subsidiary. The list does not purport to exhaust every combination of participants (or instruments), but rather to focus on useful examples. Not all cases pose a problem to the same degree or in the same way, but each is included because of the perspective it offers. In each case, the taxpayers use financial instruments to shift, allocate, or centralize risk within a related group in an attempt to maximize effective risk management. By reviewing these related party cases, the inadequacy of the current tax treatment of risk-shifting within a single corporation can be demonstrated, and the inconsistency in the U.S. taxation of hedging by "single economic units" (both related corporations and branches of a single corporation) can be explored.

A. *Case 1: U.S. Corporation with Domestic Subsidiary*

1. Basic Financial Contract

a. *Consolidated Group*

In this case, Taxpayer is a U.S. corporation that is a member of an affiliated group of corporations as defined under the consolidated return provisions.¹²³ Specifically, Taxpayer is a subsidiary corporation

example, if a branch in country *B* needs to enter into a swap hedging contract with the home office in country *A*, but is concerned about problems arising from the tax treatment of such an interbranch contract, it could instead enter into the hedge with a related corporation which would itself hedge that risk with the home office. Assuming this kind of sandwich transaction would be recognized for tax purposes, it nonetheless is not a particularly attractive alternative due to the inefficiency and the transaction costs of involving an additional party and another contract. See, e.g., Bruce Hains et al., *U.S. Taxation of International Banks*, 4 INT'L TAX REV. 521 (May 1993) (raising the possibility that the intermediary subsidiary might be treated as a conduit); Samuels & Brown, *supra* note 7, at 562 (questioning whether such back-to-back transactions would be respected).

¹²³ Pursuant to § 1504 of the I.R.C., an affiliated group constitutes one or more chains of qualified corporations connected through stock ownership with a common parent, if two require-

with a U.S. parent and U.S. brother/sister subsidiaries. Taxpayer enters into an interest rate swap with a third party. The timing, character and source rules discussed above in Part I.A.1 for a single U.S. corporation apply.¹²⁴ The only difference that the consolidated return rules make is that after each member of the group has calculated its items of income and loss separately,¹²⁵ these amounts are combined to arrive at consolidated taxable income.¹²⁶ Several additional steps involving computations made on a consolidated basis follow.¹²⁷

If Taxpayer enters into its speculative interest rate swap with a member of the consolidated group, two additional rules come into play.¹²⁸ First, all related party transactions are subject to arm's length pricing rules, which demand that the income and loss on such transactions "clearly reflect" income.¹²⁹ Second, consolidated group rules¹³⁰ regulate the matching of the two related parties' tax treatment of the transaction.¹³¹ The basic impact of the consolidated return rules as applied to the interest rate swap is to match the inclusion of the related

ments are met. First, the common parent must directly own at least 80% of the voting power (stock) or 80% of the value of one of the qualified corporations. Second, 80% of the vote or value of each other qualified corporation must be owned directly by one or more other qualified corporations. Qualified corporations do not include I.R.C. § 501 exempt organizations, insurance companies, or foreign corporations. See I.R.C. § 1504(b) (1996).

¹²⁴ See *supra* text accompanying notes 26-33. Section 446 of the I.R.C. governs timing, and §§ 861 and 864 govern source, and character is generally considered ordinary.

¹²⁵ Separate taxable income of the member is calculated under the rules generally applicable to separate corporations, but with a few exceptions, including the treatment of intergroup transactions, dividends, net operating losses and capital gains and losses. See Treas. Reg. § 1.1502-12 (1996) (separate taxable income); § 1.1502-13 (1996) (intercompany transactions); § 1.1502-14 (1996) (intercompany distributions); § 1.1502-21T (1996) (consolidated net operating loss); § 1.1502-22T (1996) (consolidated net capital gain or loss).

¹²⁶ See *id.* § 1.1502-11 (1996) (computation of consolidated group taxable income).

¹²⁷ See *id.* §§ 1.1502-11, 1.1502-21T (e.g., net operating loss deductions and capital gains).

¹²⁸ A taxpayer might enter into a "speculative" swap position with a member of the consolidated group under the following circumstances. If an entity's role is to trade for the group's own account, it may seek to take a particular risk position. If another consolidated group member is a market maker, then a risk seeker might choose to enter into its position with the market maker member because transaction costs might be lower than if a third-party market maker were sought. The market maker member would then face the decision of how to handle that risk, in particular, whether to shift it to an unrelated party through an offsetting contract. Of course, if that is not done, then the risk seeker's decision to take the risk on behalf of the group is undone.

¹²⁹ See I.R.C. § 482 (1996) (i.e., that the pricing reflect the terms that would be charged an uncontrolled party).

¹³⁰ See *id.* § 267 (1996) (otherwise governing the timing of loss and expense from related party transactions, is generally trumped by the consolidated return regulations). See generally H.R. REP. NO. 98-432, pt. 2, at 1579-80 (1984), *reprinted in* 1984 U.S.C.A.N. 697, 1206-07 (committee reports stating that the amendments to I.R.C. § 267 were not intended to impact consolidated groups).

¹³¹ See Treas. Reg. § 1.1502-13 (1996).

parties' income and loss from the transaction. The net effect for purposes of the consolidated returns is likely to be a wash.¹³² The contract itself, however, is respected by the tax rules.

b. *Unconsolidated or Unaffiliated Related Group*

If Taxpayer's group were unconsolidated (affiliated but not filing a consolidated return) or perhaps were a controlled but unaffiliated group,¹³³ the tax results of an interest rate swap with an unrelated party would be subject to the same character, source and timing treatment as the consolidated taxpayer and the baseline taxpayer.¹³⁴

If Taxpayer enters into the swap with a related party, arm's length pricing rules would apply.¹³⁵ Although the consolidated return matching rules would not govern, other general related party coordination rules would step in to regulate the matching of income and deduction from transactions between related parties, including members of a controlled group of corporations.¹³⁶

2. Hedging Transaction: Unrelated Party

Taxpayer (member of a consolidated group) enters into an interest rate swap with a third party in order to hedge its own debt.¹³⁷ Because the swap hedges Taxpayer's own debt, this example is no different, for present purposes, than the case of the individual corporation hedging its own debt (with the additional layer of consolidated return rules regarding the members' separate taxable incomes, fol-

¹³² Although the general purpose and effect of the consolidated return rules is to minimize the importance of the treatment of individual members, in particular cases it is nonetheless relevant which transactions are reported on which members' books (for example, when different members of the group use different accounting measures or when a member is sold or leaves the consolidated group).

¹³³ For example, if the group were between 50% and 80% commonly owned.

¹³⁴ Thus, if a member of a controlled group entered into an interest rate swap with a third party, § 446 of the I.R.C. would govern timing, character would likely be ordinary, and source would be covered by §§ 861 and 864 of the I.R.C. See *supra* text accompanying notes 36-39.

¹³⁵ See I.R.C. § 482 (1996).

¹³⁶ For purposes of § 267 of the I.R.C., which limits related party losses and deductions, a controlled group is defined as one or more chains of corporations connected through stock ownership with a common parent where more than 50% of the vote or value of each corporation (except the common parent corporation) is owned by one or more of the other corporations and the common parent owns more than 50% of the vote or value of at least one of the other corporations. I.R.C. § 267(f) (1996) (citing and modifying the definition in I.R.C. § 1563(a) (1996)).

¹³⁷ Assume that here, as with the baseline taxpayer, the taxpayer seeks to transform its floating rate debt into fixed rate debt.

lowed by the computation of special consolidated items).¹³⁸ The one caveat is that members of a consolidated group are required to allocate and apportion interest expense (and interest equivalents) of each member of the group as if the group were a single corporation.¹³⁹ Here, if all assets owned by the consolidated group are U.S. assets, then any income or loss on the hedge is U.S. source.

If Taxpayer is a member of an unconsolidated affiliated group or is a member of a controlled group, the tax treatment of the hedging transaction is the same as for the baseline taxpayer hedging its debt.¹⁴⁰

3. Hedging Transaction: Related Party

With the basic framework for consolidated and affiliated group hedging transactions established, we can consider the interesting case of a taxpayer (here, a member of the consolidated group) hedging with a member of its own consolidated group. Instead of directly entering into a third-party interest rate swap, Taxpayer turns to a member of the group. Often this member may serve as the risk pooling and management center for all of the group's interest rate risk.¹⁴¹ The risk management function can be handled in two different ways.¹⁴²

¹³⁸ See *supra* text accompanying notes 34–47.

¹³⁹ All interest expense is allocable to all of the gross income of the members, and all the assets of all the members are taken into account in apportioning the interest expense. See I.R.C. § 864(e)(1) (1996); Treas. Reg. § 1.861–11T(c) (1988). Financial corporations within the consolidated group are treated separately, however. See Treas. Reg. § 1.861–11T(d)(4)(i). Thus, the consolidated group is bifurcated into two separate affiliated groups: the financial group and the nonfinancial group. See *id.* § 1.861–11T(d)(4)(ii). Keeping interest expense within each group is intended to provide a fairer approximation of the consolidated picture because the financial group would predictably provide a disproportionate amount of interest expense.

¹⁴⁰ See *supra* text accompanying notes 36–47.

¹⁴¹ As in the prior examples of interbranch (and inter-desk) hedging, it is useful to specify the business necessity and motivation underlying the intra-consolidated group hedges. Certainly, a member with a risk to hedge could enter into an offsetting contract with an unrelated third party, and by doing so would have immediately transferred the risk (economically) outside the entire group. Often, however, that hedging route may not be the most efficient or cost effective hedging strategy for the group. Such a strategy would require each member to have someone monitoring and negotiating third-party contracts—expertise would be diluted and information costs likely higher because each hedge would be performed with a third party. If, in the alternative, one member of the group handles the risk management function, then several benefits can be achieved: (1) risk management/hedging expertise is centralized; (2) transaction costs are reduced because of shared information; and (3) the number of third-party hedging contracts necessary may be reduced because (a) the risk manager can monitor whether, for example, member A's currency risk is offset by member B's currency position (both risks which could be transferred for monitoring and accountability purposes to the risk manager), and (b) the risk manager can enter into a single third-party contract to offset currency risk faced by both member A and member B.

¹⁴² See Frank Hertz et al., *Taxation of Hedging Transactions: Final and Proposed Regs Leave*

First, the group members may enter into contracts with the risk manager to explicitly shift all of the particular risk to the risk manager. For example, in this case Taxpayer enters into an interest rate swap with the risk manager in which Taxpayer agrees to pay the fixed rate in return for receiving the floating rate. As a result, the risk manager bears the risk of interest rate movement and Taxpayer has hedged its risk. The risk manager then assesses its net risk (perhaps having taken on other members' interest rate risk as well) and hedges the net exposure with a third party. Effectively, each member of the group has transferred interest rate risk by contract to the risk manager who hedges the net risk with a third party. The result is that each member, viewed individually, has economically hedged this risk, and the group, viewed as a whole, has hedged the risk as well.

An alternative way in which the risk manager could operate does not involve a contract between Taxpayer and the risk manager. Instead, the risk manager simply analyzes the consolidated group as a whole, assesses the net interest rate risk position of the group and enters into a third-party hedge to offset it.¹⁴³ In that case, the group, taken as a unit, is hedged for the particular risk, but the members of the group viewed individually are not hedged because of the absence of an offsetting contract between each member and the risk manager.¹⁴⁴ Thus, although each member may consider itself to have neutralized its interest rate risk, on a stand alone basis each member's books show a risk (and ultimately unpredictable gain or loss) from interest rate movement.

Depending on the hedging pattern used, the tax treatment differs. Under the basic hedging rules, various advantages (including matched timing and character treatment of the hedge and hedged item) inure to taxpayers whose economic hedge is treated as a hedge for tax purposes as well.¹⁴⁵ To qualify as a tax "hedging" transaction, the hedge

Many Unanswered Questions, 64 TAX NOTES 1597, 1610-12 (1994) (describing alternative structures for group hedging activity). See generally 59 Fed. Reg. 36,394 (1994) (preamble to Prop. Treas. Reg. §§ 1.446-4(e), 1.1221-2(d),(e),(f)); I.R.S. Notice 94-49, 1994-1 C.B. 358, 359 (describing single and separate entity approaches); Charles T. Plambeck, *Comments on the Proposed Hedging Regulations*, 94 TAX NOTES TODAY 245-28 (Dec. 15, 1994) [hereinafter Plambeck, *Comments*].

¹⁴³ The new rules that were specifically designed for consolidated groups in recognition of their special circumstances are discussed *infra* at text accompanying notes 150-61.

¹⁴⁴ See, e.g., Plambeck, *Comments*, *supra* note 142; Reich, *supra* note 7, at 18.

¹⁴⁵ See, e.g., Treas. Reg. §§ 1.1221-2(a) (1996) (capital assets do not include property that is part of a hedging transaction); § 1.446-4(b) (1996) (to clearly reflect income, the gain, loss, income or expense from the hedge must match the corresponding amounts from the hedged item); see also I.R.C. § 1256(e) (1996) (exception to the mark-to-market treatments available for qualified hedging transactions).

must reduce the taxpayer's own risk.¹⁴⁶ Hedging a related party's risk (for example, as described in the alternative consolidated group hedging pattern) does not constitute a "hedging transaction" for either the member taxpayer or the risk manager because neither possesses *both* an underlying risk and an offsetting hedge. Each holds only one of the two transactions rather than a pair.

Thus, in the first pattern of related party hedging (actual contract between member-taxpayer and risk manager), Taxpayer's interest rate risk is hedged for tax purposes because the related-party swap serves as the "hedge" for Taxpayer.¹⁴⁷ The related party oversight rules apply, as they did in the "speculative" consolidated group swap.¹⁴⁸ In the case of the alternative pattern of consolidated group risk centralization, the absence of a contract between the group members (the taxpayer and the risk manager) means that the taxpayer has not entered into a hedging contract. Moreover, the risk manager does not have a hedge because its contract with the third party does not hedge a risk of the manager. Therefore, under the basic hedging rules, there would be no hedge and no coordination of the timing and character of the taxpayer's third-party debt and the risk manager's third-party swap.¹⁴⁹

However, hedging rules drafted specifically for consolidated groups provide additional flexibility and grant some formal recognition to the variety of related party hedging in the consolidated group context. Under these rules, two different tax treatments for consolidated group hedging transactions are available: (1) the single entity approach, and (2) the separate entity approach.¹⁵⁰

The single entity approach applies in the absence of a separate entity election¹⁵¹ and permits members of the consolidated group to hedge the risk of other members as if the separate corporations were

¹⁴⁶ See Treas. Reg. §§ 1.1221-2; 1.446-4(a), (b).

¹⁴⁷ The risk manager may or may not have a "hedge transaction" of its own. To qualify for hedging treatment under Treas. Reg. § 1.1221-2, the position being hedged (in the case of the risk manager, that is the swap with the member) must be ordinary property. Treas. Reg. § 1.1221-2(b)(1). For these purposes, property is ordinary to a taxpayer "if a sale or exchange of the property by the taxpayer could not produce capital gain or loss regardless of the taxpayer's holding period when the sale or exchange occurs." *Id.* § 1.1221-2(c)(5)(i). The contract is most likely to be ordinary if the manager is a dealer in financial instruments and the contracts are inventory.

¹⁴⁸ See I.R.C. §§ 482, 1502 (1996).

¹⁴⁹ Important benefits of the tax system's recognition of a hedge include coordination of timing and character to ensure that a net zero economic position does not produce a tax effect. See, e.g., *supra* text accompanying notes 36, 103-111.

¹⁵⁰ See Treas. Reg. §§ 1.446-4(e)(9); 1.1221-2(d).

¹⁵¹ See *id.* § 1.446-4(e)(9)(i), (ii).

all divisions of a single corporation.¹⁵² A related party contract, such as the swap between Taxpayer and the risk manager, would be unnecessary and (in the absence of a separate entity election) would not constitute a hedging transaction or a hedged item. The risk manager's third-party swap would be considered to hedge Taxpayer's debt instrument.¹⁵³ Thus, the character of the third-party hedge would be determined by reference to Taxpayer's original transaction (the debt).¹⁵⁴ Similarly, the timing of the third-party hedge and Taxpayer's position would be matched.¹⁵⁵

The character and timing treatment available under the single entity regime provide economically sensible results if in fact there is no related party contract and the focus is only on a group basis, rather than a stand-alone analysis.¹⁵⁶ The character of the risk-creating transaction (Taxpayer's debt) and the hedge (the risk manager's third-party swap) match, as do their timing. Given that these are the only contracts, all is balanced on a net group basis (i.e., when a consolidated return is filed).¹⁵⁷ To the extent the members of the group view them-

¹⁵² See *id.* § 1.446-4(e)(9)(i) ("all of the members are treated as if they were divisions of a single corporation").

¹⁵³ See *id.* §§ 1.446-4(e)(9)(i); 1.1221-2(d)(1).

¹⁵⁴ See *id.* §§ 1.1221-2(a)(1), 1.1221-2(b), 1.1221-2(d)(4) Ex. 1. If a transaction is identified by the taxpayer as a hedging transaction, then any gain on the hedge is considered ordinary income. A loss on a transaction identified by the taxpayer as a hedge, however, is not necessarily ordinary in character. A transaction must actually qualify as a hedging transaction, not just be identified as such, in order for a loss on the hedge to be treated as ordinary, and not capital. This is the taxpayer whipsaw of the § 1221 hedge identification requirement. *Id.* § 1.1221-2(e), (f).

¹⁵⁵ See Treas. Reg. § 1.446-4(e).

¹⁵⁶ See, e.g., Plambeck, *Comments*, *supra* note 142.

¹⁵⁷ Of course, the absence of a contract between taxpayer and the risk manager means that both of their accounts, when viewed separately, do not balance for either economic or tax purposes. Given the earlier analysis, which highlighted both the business reasons for inter-member hedges (keeping track of responsibility for risk; quantifying and specifying the nature and location of risk) as well as the tax benefits (ensuring that each member's positions are balanced, in addition to the group as a whole, so that any computation that needs to be done on an individual basis, e.g., upon sale or departure of a member from the group, is an accurate reflection of the member's situation), this raises the question of why all consolidated groups do not use inter-member transactions.

With respect to the business reasons for such contracts, there are some cases in which there is less pressure to track risk responsibility and less capacity in the internal accounting structure to maintain separate risk balances—probably because the issues arise fairly infrequently. For example, if a U.S. manufacturing subsidiary that operates primarily in dollars suddenly finds itself with a Deutschmark risk on a contract, it may turn to its parent's main treasury department and ask them to take care of the risk. If the situation arises infrequently it may not be necessary to use inter-member contracts to monitor each member's role.

Even in this case, however, it arguably would be useful to have such contracts for tax purposes in the event that calculations must be made at some point on a separate entity basis. If the tax

selves as part of a single economic unit, the hedging effect is maintained for tax as well as economic purposes. Floating rate interest payments owed by the group (specifically by taxpayer) are offset by the right to receive comparable floating rate payments under the third-party swap, leaving the "group" with an obligation to pay the equivalent of a fixed rate interest payment.

A separate entity election is available for taxpayers that use a central risk manager but enter into intercompany swaps to actually transfer the risk within the consolidated group.¹⁵⁸ To qualify for this treatment, the risk manager of the group must account for transactions on a mark-to-market basis.¹⁵⁹ This requirement may pose a serious barrier to the separate entity election if the risk manager is not usually on that accounting method. In addition, the consolidated group must make an overall choice between single entity and separate entity treatment—a decision that requires the group to consider what hedging scenarios will be most common—and whether it is preferable to balance accounts on a group basis or a stand-alone basis.

Of course, none of the consolidated group hedging rules apply to a taxpayer that is part of an affiliated but unconsolidated group or part of a controlled group.¹⁶⁰ In those cases, each taxpayer must hedge its own risks, although it can do so through related party contracts. That hedging is governed by the rules for a single U.S. corporation except for the additional application of the related party rules.¹⁶¹

department has a prominent role in business decisions, the entity would probably prefer having the inter-member contracts because the separate accounts have relevance and the tax department would want to keep them correctly. Two possible explanations for the absence of contracts in such cases despite the tax role they might play someday are: (1) if the situations are infrequent and not substantial compared to the overall activity of the member, the relative impact of an unbalanced position for tax purposes might not be tremendous; and (2) the tax department might not play a significant role in business decisions.

There appears to be no tax policy reason to penalize corporations operating under these conditions. This is implicitly the view adopted in the final consolidated group hedging regulations which offer the single entity approach as the baseline. Moreover, the single entity approach is consistent with the general tax view of consolidated groups as a single taxpayer.

¹⁵⁸ See Treas. Reg. §§ 1.446-4(e)(9)(ii); 1.1221-2(d)(2).

¹⁵⁹ See *id.* §§ 1.446-4(e)(9)(ii); 1.1221-2(d)(2)(ii)(B).

¹⁶⁰ See *id.* §§ 1.1221-2(d)(1), (2) (prescribing the hedging treatment for a consolidated group); 1.446-4(e)(9)(i), (ii) (same); 1.1221-2(d)(3) (defining "consolidated group" pursuant to I.R.C. § 1502 and the regulations thereunder); 1.446-4(e)(9)(iii) (same); T.D. 8653, 1996-12 I.R.B. 41, 61 Fed. Reg. 517, 517-518 (Jan. 8, 1996) (preamble to the final consolidated group hedging rules under I.R.C. §§ 446 and 1221 regulations).

¹⁶¹ See I.R.C. §§ 267, 482 (1996).

B. Case 2: U.S. Corporation with Foreign Subsidiary

1. Basic Financial Contract

Taxpayer, a U.S. corporation with a wholly-owned foreign subsidiary, enters into a speculative interest rate swap with a third party. The tax treatment is the same as that for the baseline taxpayer with no related parties.¹⁶² If instead of entering into the swap with a third party, Taxpayer enters into it with the foreign subsidiary, the tax results are the same except that arm's length pricing is required¹⁶³ and related party matching principles apply.¹⁶⁴ Consolidated group rules are inapplicable because a foreign corporation cannot be a member of a consolidated group.¹⁶⁵

2. Hedging Transaction

If Taxpayer enters into an interest rate swap with a third party to hedge its debt, the timing and character of income or loss on the swap is determined as outlined above in the baseline hedge scenario.¹⁶⁶ Because the interest rate swap functions as an interest equivalent,¹⁶⁷ Taxpayer is subject to the allocation and apportionment of swap expense for source purposes.¹⁶⁸

Assuming the hedge qualifies as a properly identified cost of borrowing, however, any gain reduces interest subject to allocation and apportionment. Taxpayer "owns" some foreign assets based on its ownership of the foreign subsidiary.¹⁶⁹ So, under the apportionment formula, a portion of any swap loss would be foreign source. As noted earlier, because the United States taxes residents on their worldwide income regardless of source, the primary effect of source of income for a U.S. corporation involves calculation of the foreign tax credit.¹⁷⁰

¹⁶² See *supra* text accompanying notes 26–33. Because the swap is not an interest equivalent and does not alter the effective cost of borrowing, no allocation or apportionment is required, so any gain or loss is U.S. source (residence of the taxpayer). See *supra* text accompanying notes 39–43.

¹⁶³ See I.R.C. § 482.

¹⁶⁴ Generally, a taxpayer must use the cash method of accounting for deductions of amounts owed to related foreign persons. See Treas. Reg. § 1.267(a)-3(b)(1) (1992).

¹⁶⁵ See I.R.C. § 1504(b)(3) (1996).

¹⁶⁶ See *supra* text accompanying notes 34–47.

¹⁶⁷ See Treas. Reg. § 1.861-9T(b)(4) (1996).

¹⁶⁸ See *id.* § 1.861-9T.

¹⁶⁹ See generally Treas. Reg. §§ 1.861-9T(g), (h)(3)–(5), 1.861-12T(c)(2)(vi), ex. 2 (1996).

¹⁷⁰ See *supra* text accompanying notes 4–5, 70–71.

If Taxpayer enters into this swap with its foreign subsidiary instead of a third party, the only difference is the application of the related party oversight requirements.¹⁷¹

C. Case 3: Foreign Corporation with U.S. Subsidiary

Obviously, foreign corporations with no transactions or activities in the United States are not subject to U.S. income tax. Moreover, the U.S. subsidiary of a foreign corporation is usually taxed no differently on its financial instrument transactions, including hedging transactions, than the baseline domestic corporation considered in Part I.A.1. If the U.S. subsidiary of a foreign corporation enters into a hedging transaction with the foreign parent, no new rules apply. As with an entirely domestic related party hedge, the contract is fully recognized for tax purposes, and the only special rules are arm's length pricing and coordination rules.¹⁷² Paralleling the case of a U.S. parent and a foreign subsidiary, a U.S. subsidiary cannot file a consolidated return with a foreign parent.¹⁷³

III. COMPARISON OF THE TAXATION OF RISK-SHIFTING WITHIN A SINGLE CORPORATION TO RISK-SHIFTING WITHIN A GROUP OF RELATED CORPORATIONS

This Part examines how and why U.S. taxation of risk-shifting within a corporation is not only arbitrary, but also inconsistent with the tax treatment of risk-shifting within a multinational group of related corporations. The inconsistency is explored through a comparison with the three related party cases outlined in Part II. The comparative analysis begins with the determination that interbranch transactions are not significantly different in kind from related party transactions. The concerns raised by both transactions are grounded in the same intuitions about taxpayer behavior. As a result, comparable tax rules should be considered. This Part first reviews the common features and

¹⁷¹ See I.R.C. §§ 267, 482 (1996); see *supra* text accompanying notes 135–136. The basic rules applicable would still be § 446 of the I.R.C. for timing, and § 1221 for ordinary character. Sourcing under the allocation and apportionment rules would result in some fraction of any loss going to reduce foreign source income. See Treas. Reg. § 1.863–9T (1996).

¹⁷² See I.R.C. §§ 267(a)(3), 482 (1996). The precise application of the matching rules in § 267 of the I.R.C. for payments by a U.S. person to a related foreign person has been debated. See *Tate & Lyle, Inc. v. Commissioner*, 87 F.3d 99, 101, 103 (3d Cir. 1996) (reversing the decision of the Tax Court and finding Treas. Reg. § 1.267(a)-3, which requires an accrual basis taxpayer to defer deductions for certain amounts paid to a related foreign person until the year actually paid, a valid exercise of the Secretary's power under I.R.C. § 267(a)(3) (1996)).

¹⁷³ See I.R.C. § 1504(b)(3) (1996).

risks of interbranch and related party transactions and then evaluates the handling of these concerns in the related party context. Finally, this Part reflects on the fact that, unlike other major industrialized nations, the United States does not recognize contractual risk-shifting within a corporation.¹⁷⁴ Part IV will culminate the analysis by translating some of the observations from this Part into recommendations for the treatment of risk-shifting within a multinational corporation.

A. *Common Features, Common Concerns, Dissimilar Rules*

1. Basic Comparison

The United States' examination of internal risk-shifting and interbranch transactions typically starts with the premise that a taxpayer cannot deal with itself. The view seems intuitively sensible because the economic benefits and burdens of ownership do not change following such an internal transaction. A typical example would be the absurdity of selling your house to yourself. Carrying this premise forward, the conclusion is that branch transactions cannot be acknowledged by the tax system because they too are examples of self-dealing. Under this framework, a comparison with related party transactions is rejected because such cases involve two distinct taxable entities (e.g., two corporations owned by the same shareholders). A rapid dismissal is unwarranted, however, and in fact, the related party analogy is an illuminating one. Although the two cases are different when measured by a standard that judges self-dealing based on legal status, they are similar when measured by a standard that judges self-dealing based on economic ownership.

The element that links related party transactions and interbranch transactions, and that underlies the special tax issues they raise, is common ownership. Ultimately, individuals are the smallest taxable units and are the true bearers of the tax burdens. Corporations are legal fictions and their status as taxable entities is merely a structural feature of our system.¹⁷⁵ In the end, it is individual taxpayers who bear even the corporate tax.¹⁷⁶ When two corporations that are commonly owned (i.e., ultimately owned by the same individuals) enter into a

¹⁷⁴ See generally *supra* note 4.

¹⁷⁵ Although some would argue that multinationals have become so powerful, and to some degree independent, that they should be thought of as taxpayers in their own right.

¹⁷⁶ Even though the specific incidence of the corporate tax is highly debated (e.g., shareholders, workers, consumers), the framework of the debate demonstrates the shared understanding that it is individuals who truly bear tax burdens, and that the only question is which individuals

transaction, it may be viewed in substance (that is, economically), but not form (legal status), as self-dealing.¹⁷⁷

The question, then, is what is the concern raised by common economic ownership. The primary fear is that the parties will behave in a way that maximizes their joint after-tax benefit at the expense of the government. Although such a scenario is not impossible when unrelated parties deal, it is particularly common and problematic with related parties because tax rules locate gain and loss in specific taxpayers by relying on the parties' stated transaction terms and prices. If the two participants are commonly owned, it is less economically relevant where the profit is booked because a single set of owners bears the benefits and burdens of both companies. As a result, common ownership may lead the parties to structure their transactions and engage in pricing strategies designed to maximize their joint after-tax position instead of each party maximizing its own benefit, which is the economically rational behavior of an independent entity. The abuse potential of strategic profit-shifting by taxpayers exists regardless of their legal structure as related subsidiaries or as branches.

The response of the tax system to related party transactions has been to recognize them, but simultaneously to limit the potential abuse.¹⁷⁸ The system requires scrutiny of the pricing and timing of related party transactions to ensure that the transactions are arm's length and that the participants are unable to manipulate their ac-

and in what proportion. See, e.g., Richard L. Doernberg, *Overriding Tax Treaties: The U.S. Perspective*, 9 EMORY INT'L L. REV. 71, 89 (1995) ("Those who have studied the incidence of the corporate tax have reached inconclusive results."); Emil M. Sunley, *Corporate Integration: An Economic Perspective*, 47 TAX L. REV. 621, 636 (1992) ("The incidence of the corporate income tax has been long debated. The popularity of the corporate tax may well be due to the fact that no one knows who pays it." (footnote omitted)).

¹⁷⁷ Focusing here on the ultimate economic ownership highlights the similarity between related party transactions and interbranch transactions. There is some sense, however, in which risk-shifting is "real" as between related companies but not as between branches. Although related companies are commonly owned and thus one economic entity vis-a-vis the ultimate owner, individual creditors of a company are generally forced to view that company in isolation and cannot call upon the resources of the broader economic group. This dichotomy arises from the imperfect intersection of economics and law. As a factual matter, a single ultimate owner may control several wholly owned subsidiaries, but that economic observation is obscured by the formal decision to grant each corporation an identity distinct from its related corporations and from its owner. This kind of distinction, however, may have less relevance here than first appears because interbranch and related party transactions should be arm's length, so it is not an occasion for one-sided shifting of assets out of a corporation. Related party transactions and interbranch transactions are similar because of common ownership, but appear different because of the formal distinctions that are imposed and given weight (for example, the general requirement that the existence of a corporation as distinct from its shareholders be respected. See, e.g., *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 439 (1943)).

¹⁷⁸ See, e.g., I.R.C. §§ 267, 482 (1996).

counting rules to accelerate deductions and defer income. To the extent that taxpayers stay within the boundaries of "non-abusive" transactions, however, the related party transactions are fully respected.

The tax system treats interbranch transactions differently from related party transactions, despite the economic parallel. In the case of related party transactions, the tax system balances the danger of common economic ownership with respect for legal status as separate entities. Thus, related party transactions are allowed (subject to certain rules) because they are not self-dealing, whereas interbranch contracts are not allowed because the participants are parts of a single legal entity and thus are engaged in self-dealing. This picture, however, overstates the distinction between branches and subsidiaries on legal status grounds and obscures the more complicated parallels.

The reason that branches do matter and that their risk shifting is important for the tax system to recognize is because various rules (e.g., jurisdiction, source rules, regulatory regimes, currency rules) ascribe some significance to the branch itself even though the branch is not considered an independent legal entity. Where the tax rules create significant legal distinctions within a single economic entity, the tax system must take account of the resulting discrepancy in designing other tax rules.¹⁷⁹ The risk here is not that income allocations will be distorted by the taxpayer trying to minimize tax, but that income allocations will be distorted by tax rules that are noneconomic and potentially over-inclusive or under-inclusive of taxable income. If some legal rules treat a single corporation (a legal status determination) as *de facto* multiple entities then it may be necessary for certain tax rules to do so in order to produce economically sensible taxation that does not distort the taxpayer's behavior. Thus, if branches of a single corporation face some rules that rely on the independent status of the branches, then it may be necessary to acknowledge interbranch transactions in order to tax income more accurately.

What this discussion suggests is that branches and subsidiaries are more similar than initially indicated on both legal status and economic grounds. Related parties are like branches in that they have single economic ownership; branches are like related parties in that some legal distinctions treat them as separate. These observations again encourage development of tax rules that reflect the complex interac-

¹⁷⁹ For example, such rules include I.R.C. § 475 which specifies a particular accounting method for a taxpayer's dealer function, § 988(b)(1)(B) which determines functional currency on the basis of each business unit, and § 864 which essentially permits the United States to tax foreign corporations only on the activities of the U.S. branch of the corporations.

tion of economics and law. Moreover, the significance of any special fear regarding branch transactions is substantially vitiated by the recognition that the government's real cause for concern is the same in both cases—that the two sides of the transaction share a single economic owner and economic goal. As a result, both interbranch and related party transactions should be analyzed through the interaction of economic income (i.e., common ownership) and legal rules (both legal status (i.e., incorporation) and legal distinctions (e.g., jurisdiction and source)).

The risk of taxpayers engaging in abusive transactions exists with both related party and branch contracts because of two basic facts. First, the existence of separate taxing jurisdictions enables a taxpayer to shift income strategically to a lower or no-tax jurisdiction. Second, the fact that tax rules ascribe some independent tax relevance to branches and subsidiaries provides other opportunities to place income strategically.¹⁸⁰ For related party transactions, the tax system overcomes these risks by applying special pricing and timing rules. Rather than relying on the "market" to set contract terms, the regulations provide the framework. If this mechanism works in the related party context, it should be feasible with interbranch transactions as well. In other words, from an anti-abuse perspective, can self-dealing (transactions within the same entity as defined by legal status) be any different from related party contracts when the economic substance is understood and considered? Why would the rules governing related parties not provide adequate protection in the interbranch context?

Despite the parallels, the Internal Revenue Service (the "Service") has declined to apply § 482 of the I.R.C. to interbranch transactions except in the context of an Advanced Pricing Agreement ("APA") negotiated with a country with which we have a treaty.¹⁸¹ The Service

¹⁸⁰ The emphasis in the analysis on taxable units and jurisdiction is not the same as saying this is all about source and that good source rules would solve the problem. Expressing it as a question of source may not help much because the question then becomes whether source should be different here?—and if so, why? If the why turns on the role of the intermediary branches, we are back to this question about taxable units, at least to some extent. Moreover, problems arise even in a domestic context with inter-desk transactions or any other case where different pieces of the economic whole owned by a taxpayer face different tax rules (e.g., dealer status, loss limitation, etc.). See *supra* text accompanying notes 103–11.

¹⁸¹ See *First APA Covering Cross-Border, Interbranch Bank Transactions*, 1995 DAILY TAX REP. 45, d3 (Mar. 8, 1995). The IRS has taken the position that such treatment is not available under domestic tax law, but that the taxation of permanent establishments and business profits under the treaties permits (but does not require) treating interbranch transactions like related party transactions. The practicing bar has continued to argue that interbranch transactions should be governed by the transfer pricing rules in § 482 of the I.R.C. and that the taxpayers would then demonstrate that their activities satisfied the arm's length requirements. *Banks Urge IRS to Keep*

and Treasury, however, have recently expressed interest in applying § 482 transfer pricing principles to certain cross-border interbranch financial transactions and "are drafting proposed rules under sections 861 through 865 that could introduce elements associated with the arm's length principle in determining income allocations from cross-border interbranch transactions in derivatives, foreign exchange, securities, and other financial products."¹⁸² The Service, though, has emphasized that "the proposed rules would not provide blanket recognition of separate entity treatment of banks and financial institutions with branches, adding the government does not anticipate taking such action in any other regulation or proposal."¹⁸³ These developments indicate some willingness on the part of the government to rethink the traditional view of branch transactions.

2. Insights from Consolidated Groups

In addition to the observations drawn from a comparison of interbranch and related party transactions, more insights can be obtained from studying consolidated groups. The tax treatment of consolidated groups provides further evidence of the flexibility the tax system is capable of using to improve economic taxation in a regime that is based on legal determinations of taxpayer identity. Although consolidated groups approach these questions from the opposite direction (by treating legally separate entities as a single entity for tax purposes), the accommodations made by the consolidated return hedging rules acknowledge: (1) that underlying common ownership is significant, and (2) that a combination of business circumstances and regulatory treatment can make it matter where items are located, even in a commonly owned group.

Thus, separately incorporated entities are treated as a single entity for purposes of the consolidated hedging rules if that treatment more accurately reflects the economic activity of the group as a whole. For example, consolidated groups that use centralized risk management and have the risk manager monitor and hedge members' risk, but do not use inter-member contracts to explicitly shift the risk, may be treated as a single entity for hedging.¹⁸⁴ A third-party risk faced by one

Pledge to Publish Guidance on Interbranch Trading APAs, 1996 DAILY TAX REP. 55, d11 (Mar. 21, 1996).

¹⁸² *U.S. May Apply Arm's Length Elements to Interbranch Transactions, Official Says*, 1996 DAILY TAX REP. 130, d5 (July 8, 1996).

¹⁸³ *Id.*

¹⁸⁴ See *supra* text accompanying notes 150-57.

member can be hedged by the risk manager without an inter-member contract, and the hedge will be accorded the full benefits (e.g., coordinated character and timing) of a tax hedge. The existence of single entity and separate entity hedging treatment for consolidated groups grew out of the uneasy and sometimes conflicting intersection of economic substance and legal rules.¹⁸⁵ The tax law starts with legal status (separate corporations) but incorporates economic substance by allowing consolidated filing. Nonetheless, the significance of each corporation as a separate entity is not eliminated, and separate status can play an important role in hedging. Ultimately, the consolidated group examples reveal that the decision to incorporate is not determinative and that the tax law must, at least in some circumstances, look beyond formal status.

3. Integrating the Analysis of Interbranch, Related Party and Consolidated Group Transactions

Following the theme implicit in the taxation of consolidated groups, if treating branches as separate and recognizing their interbranch contracts provide a tax result that is more consistent with the underlying economics and is thus less likely to distort taxpayer behavior, then that treatment should be seriously considered.¹⁸⁶ The point is not that legal status is irrelevant and only economic reality matters. Rather, the point is that in order to design tax rules that follow the economic activity and do not unintentionally distort taxpayer behavior, we must recognize both the overriding impact of common ownership for separate, related entities and the impact of legal distinctions that do not rise to the level of producing legally separate entities. It is through an understanding of these factors that the existence of three distinct cases—(1) related party transactions; (2) special consolidated group hedging; and (3) recognized interbranch transactions—could logically co-exist.

¹⁸⁵ See, e.g., Preamble to Proposed Regulations for Hedging Transactions by Members of a Consolidated Group, 59 Fed. Reg. 36,394 (July 18, 1994) (discussing the role of single entity versus separate entity treatment of consolidated groups with reference to the business and economic structure of the activities and the general approach under consolidation).

¹⁸⁶ The result is not one of unfettered taxpayer electivity. As noted earlier, various anti-abuse measures temper the risks of strategic taxpayer behavior in a commonly owned group. See *supra* text accompanying notes 128–31, 135–36.

Also, the “check-the-box” system of entity classification outlined in Treas. Reg. § 301.7701–1, –2, –3 reveals the trend with respect to taxpayer choice and flexibility in the role of legal status generally. The regulations, which identify certain foreign and domestic entities as corporations and permit the remainder to elect their classification for federal tax purposes, facilitate flexible entity classification. 61 Fed. Reg. 66,584, 66,585 (1996).

In the first case of separate, related corporations, legal status prompts the expectation that the related party transactions will be recognized. In fact, that result may be necessary to the extent that significance attaches to the corporations' separate status, for example, different accounting rules or jurisdictions (legal distinctions). But it is the understanding of common ownership that tempers the recognition of the related party transactions with the application of anti-abuse rules (I.R.C. §§ 267, 482). The second case (consolidated groups), which covers those situations in which common economic ownership may play a more significant role than the separate legal status, permits the separate legal status to be effectively ignored for some purposes. Finally, the third case (recognized branch transactions) reflects a different combination of the factors. There, despite the absence of legally separate entities, the existence of certain legal distinctions (for example, jurisdiction) renders the branches' separateness more important in trying to tax economic income and minimize distortions in taxpayer behavior. Nonrecognition of interbranch transactions is neither fundamentally obvious given the complexity of factors acting upon the taxpayers, nor required for consistency with the taxation of legally separate taxpayers.¹⁸⁷

But what of the hesitancy evident in recognizing interbranch transactions? The analysis above describes the abuse potential as comparable in both related party transactions and interbranch transactions and proposes that similar anti-abuse rules could govern both. Are there reasons, however, why we may trust our anti-abuse measures more in the related party context? For example, although both cases involve common economic ownership, if, as a practical matter, related but separate companies have different managers and employees, there may be some level of competitiveness, such as performance-based compen-

¹⁸⁷ It is interesting to note that the tax law seems to have done better with nonfinancial groups. If a taxpayer either (1) produces inventory property in the United States and sells it in a foreign country, or (2) produces inventory property in a foreign country and sells it in the United States, then the income is considered partly from sources within the United States and partly from sources outside. See Treas. Reg. § 1.863-3(b)(1) (1996). In order to apply source rules, the gross income must first be allocated to production activities and to sales activities. After that, the two categories are sourced according to special rules. The allocation of income between production and sales activities is determined under one of several methods—including the independent factory price ("IFP") method. Under the IFP rule, if a producer regularly sells part of its output to wholly independent distributors and thereby demonstrates an independent factory price, then that IFP is used to establish the portion of gross sales to retail customers that is allocated to production activities. Effectively, this rule can be understood as treating the domestic manufacturing branch as if it were selling the goods to the foreign distribution branch at the same price it sold to the unrelated distributor. See *id.* § 1.863-3(b)(2).

sation, that "assists" in § 482's task of ensuring arm's length pricing in related party contracts. This argument, however, is significantly undermined by the observation that the same dynamic occurs with branches of a single legal entity competing to show their value.¹⁸⁸ Nonetheless, other regulatory and corporate reporting requirements may place additional pressure on separate subsidiaries to more fairly report their transactions. But if these mechanisms were very effective in controlling abuse, we would not expect to see the volume of transfer pricing disputes that currently exists.

B. *U.S. Resistance to Recognizing Interbranch Contracts and Risk-Shifting Within a Corporation*

The taxation of U.S. branches of foreign corporations demonstrates, perhaps most vividly, the inadequacy of the current U.S. position on interbranch transactions.¹⁸⁹ The absence of separate taxing jurisdictions would substantially moot this issue because of the consolidation-like effect it would have on interbranch transactions. That is, the legal distinctions imposed here on branches (jurisdiction), which do not rise to the level of creating separate legal status, would be eliminated, leaving the economic and legal rules in greater harmony. There would be one economic unit and there would be no legal distinctions that were imposed but not fully integrated into the tax law. The real world, however, has separate jurisdictions. In addition, the United States takes its view on legal status seriously, at least in one direction. The confusing result is that a U.S. branch is treated like a separate entity in terms of the scope of U.S. taxation because jurisdiction is primarily limited to the activities of the branch, but it is not treated as a separate entity vis-a-vis its home office.

The response to the uneconomic results created by the U.S. rules might be that it is acceptable for the corporation overall because where the United States inappropriately taxes a branch gain, the foreign country will probably tax the home office on a net loss.¹⁹⁰ But this

¹⁸⁸ See *infra* text accompanying note 58.

¹⁸⁹ Not surprisingly, the private bar has been active in advocating the use of the separate entity method either broadly (see, e.g., John A. Corry, *NYSBA Reports on Foreign Interest Expense Regulations*, 92 TAX NOTES INT'L 39-31 (Sept. 23, 1992); Jack Wilson, *Ernst & Young Comments on Foreign Banking Issues*, 92 TAX NOTES INT'L 64-3 (Nov. 4, 1992)) or at least for U.S. branches on a limited basis (see, e.g., Stephen M. Brecher et al., *Peat Marwick Clients Comment on Global Trading of Financial Products and Potential Regulations*, 91 TAX NOTES INT'L 22-19 (May 22, 1991); Alfred C. Groff & James F. Hoch, *Selected Issues in U.S. Taxation of U.S. Branches of Foreign Banks*, 1988 U. ILL. L. REV. 343, 369).

¹⁹⁰ See *supra* text accompanying notes 85-102.

analysis fails on several grounds. First, home country treatment might not ameliorate the situation. Some countries might tax the corporation on a worldwide basis, in which case there would be zero taxable income recognized in the foreign country and a gain recognized by the United States, despite the net zero economic effect. Second, many OECD countries, even if taxing the home office on a territorial basis, would recognize the interbranch transaction and thereby conclude that the home office has zero taxable income. In that case as well, the corporation would pay net positive tax on net zero income.

Third, the premise underlying the U.S. taxation of the branch is that the branch is engaging in a trade or business in the United States and should be taxed on a net income basis with respect to its U.S. operations. Effectively, the United States is recognizing the branch as an operating business that is "independent" of the home office. As discussed in detail below, viewing the branch as having net gain is not accurate, regardless of whether the branch is specifically viewed as a separate entity.

C. International Dialogue on the Interbranch Issue

The U.S. position on interbranch transactions contrasts with that adopted by most OECD countries. The 1992 OECD Model Tax Convention on Income and Capital ("1992 OECD Model Treaty") states in the business profits article that:

there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.¹⁹¹

The Treaty Commentary explains that under its view of interbranch transactions "the profits to be attributed to the permanent establishment are those which [it] would have made if instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market."¹⁹² The commentary's approach explicitly reflects an "arm's length principle," and anticipates that the use of arm's length allo-

¹⁹¹ *Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital*, art. 7(2) ¶ 191 (1992) [hereinafter *1992 OECD Model Treaty*].

¹⁹² *Commentary to 1992 OECD Model Treaty*, art. 7 ¶ 11 (Mar. 1994).

cations would extend beyond dealings with the head office to those with other permanent establishments of the entity as well.¹⁹³

In 1984, the OECD conducted a study of the taxation of banking and financial industries for which interbranch contracts are common business practice. According to the study, the majority of OECD countries, with the exception of the United States and Japan, view foreign bank branches as separate entities for purposes of interest expense calculations.¹⁹⁴ For example, they consider it necessary to take account of intra-bank payments of interest in ascertaining arm's length profits of bank branches in order to ensure that the taxation of the operating profits of the foreign bank branch is consistent in principle with the taxation of profits of other enterprises. Thus, the transactions between the branch and the home office are recognized for tax purposes.

On the specific topic of interest, the 1992 OECD Model Treaty Commentary reflects both the earlier OECD Model Treaty as well as the 1984 study. First, the 1992 Model Commentary adopts the view of the 1977 OECD Model Treaty, which permitted recognition of bank interbranch interest payments. The 1977 Model Treaty concluded that, although interest paid by a branch to its head office in return for funds generally is not deductible in computing the branch's taxable profits,¹⁹⁵ "special considerations apply to payments of interest made by different parts of a financial enterprise . . . to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises."¹⁹⁶ The commentary to the 1992 Model Treaty also references the 1984 banking study of interbranch interest payments and financial asset transactions and confirms that the Commentary "does not depart from the positions expressed in the report on this

¹⁹³ *Id.*

¹⁹⁴ The majority of OECD Member countries consider it necessary:

to take account of intra-bank payments of interest in ascertaining the arm's length profits of a branch of a bank, in order to ensure that the taxation of the operating profit of the foreign bank branch is consistent, in principle, with the taxation of the profits of branches of other enterprises.

OECD, COMMITTEE ON FISCAL AFFAIRS, *The Taxation of Multinational Banking Enterprises*, in TRANSFER PRICING AND MULTINATIONAL ENTERPRISES—THREE TAXATION ISSUES at 57 ¶ 47 (1984). Their position is based on two points: (1) the language of the OECD Model Treaty, and (2) the nature of banking business. *See id.* at 57. The United States and Japan consider there to be "no basis for requiring that intra-bank interest should be taken into account." *Id.* at 58 ¶ 52.

¹⁹⁵ *See* Commentary to 1992 OECD Model Treaty, art. 7 ¶ 18.3 (Mar. 1994) (noting the continuation of prior treatment).

¹⁹⁶ *Id.* ¶ 19 (repeating almost verbatim the language in the Commentary to the 1977 Model Treaty, article 7).

topic.”¹⁹⁷ Thus, although the OECD is sensitive to the special nature of interest, it supports the recognition of interbranch contracts that replace or mirror third-party transactions.

The international community’s focus on interbranch transactions has been directed primarily towards banks and interest payments because banks operate in branch form and because they often engage in interbranch transactions as if they were third-party contracts. However, the same observations that led to recognizing interbranch loans apply to interbranch financial instruments. Correspondingly, a number of countries have addressed the treatment of interbranch financial contracts. For example, “Canada recognizes internal hedging transactions, such as a swap between [a Canadian branch] and its head office, provided their terms are based on arm’s length principles.”¹⁹⁸ Similarly, in Italy, “transactions between the [permanent establishment, i.e., branch] and its head office or other [permanent establishments] of the same enterprise are relevant as though they were performed between distinct enterprises, . . . giving rise to actual costs and revenues.”¹⁹⁹ Other countries also recognize interbranch financial instrument transactions.²⁰⁰

Against this backdrop, the U.S. tax rules produce arbitrary and inconsistent results. The United States looks at the U.S. branch in isolation and typically taxes only the activities of the branch. Thus, if the hedging (either the interbranch hedge or the direct third-party hedge by the home office) does not get on the “U.S. books,” then the branch will appear to have gain or loss for tax purposes. In contrast,

¹⁹⁷ *Id.* The 1984 OECD banking report concluded that because the core nature of the banking business is:

to borrow money outside the enterprise for the purpose of lending it outside the enterprise, there is every reason to suppose that [most] money lent by [a] head office to a branch and vice versa . . . will in fact have been borrowed at some stage from an independent third party and will be lent eventually to independent third parties. Thus, the interest taken into account can be regarded as representing real out-goings or receipts of the enterprise as a whole . . .

OECD, COMMITTEE ON FISCAL AFFAIRS, *supra* note 194, at 57 ¶ 49.

¹⁹⁸ Stephen R. Richardson & David G. Broadhurst, *Canada*, in TAX ASPECTS OF DERIVATIVE FINANCIAL INSTRUMENTS, *CAHIERS DE DROIT FISCAL INTERNATIONAL*, vol. LXXXb (1995) 119, 136. The same rule applies for foreign branches of Canadian entities. *See id.*

¹⁹⁹ Franco Caleffi & Domenico Muratori, *Italy*, in TAX ASPECTS OF DERIVATIVE FINANCIAL INSTRUMENTS, *CAHIERS DE DROIT FISCAL INTERNATIONAL*, vol. LXXXb (1995) 295, 321. To prevent abuse, “the [Italian] regulation on transfer prices is applied to cross-border transactions carried out between enterprises, whatever their juridical form, that hold control relations (including therefore, the transactions between head-office and [permanent establishment]).” *Id.*

²⁰⁰ *See, e.g.*, Plambeck, *supra* note 117, at 687 (Australia (for banks), Denmark, Sweden, Netherlands, Norway, Switzerland).

the home country will likely recognize the balanced position because it accepts the interbranch transactions.

The U.S. response to the majority view of the OECD member countries has taken several directions. First, the United States has argued that the interpretation by the majority of OECD members of the applicable treaty provisions as requiring, as opposed to simply permitting, the separate entity approach and the recognition of intra-bank transactions is too extreme and not required by the language of the model treaty and commentary.²⁰¹ The United States maintains that its treaties do not, as some taxpayers have claimed, require separate entity treatment for branches, but simply make that an available option.²⁰²

²⁰¹ See generally Rev. Rul. 89-115, 1989-2 C.B. 130, 130-31; Rev. Rul. 85-7, 1985-7, 1985-1 C.B. 188, 188-89.

²⁰² See *id.* The United States' new treaty with Mexico initially led some commentators to speculate that the United States had begun to change its view on the calculation of business profits. Article 7(3) of the new U.S. treaty with Mexico states:

However, no such deduction shall be allowed in respect of such amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the home office of the enterprise or any of its other offices by way of royalties, fees or other rights, by way of commission for specific services performed or for management, or except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment.

See James E. Croker, Jr., *Editorial: Possible Inconsistency Between U.S.-Mexico Treaty and Section 1.882-5 Regulations*, 92 TAX NOTES INT'L 67-16 (Nov. 9, 1992). This provision, if read literally, would appear to permit U.S. branches of a Mexican bank to deduct interest paid on a loan from the home office. See *id.* However, as one commentator noted, this reading of the treaty would make it inconsistent with the United States' position under (then) Prop. Treas. Reg. § 1.882-5 which viewed interest as fungible and used a formula to determine the interest expense attributable to a U.S. branch of a foreign corporation. See *id.*

This potential conflict raised the possibility that acceptance of the separate entity method for banks in the U.S.-Mexico Treaty was intentional and was simply another unusual feature of that treaty. However, the U.S. Senate Foreign Relations Committee Report on the Mexico Treaty stated that:

[t]he Treasury Department has informed the Committee that, with regard to the above exception for banking enterprises [Art. 7], the proposed treaty is not intended to expand the allowable deductions for interest by a foreign bank operating in the United States beyond the deductions that are available under domestic U.S. law (currently provided by Treas. Reg. § 1.882-5). As indicated above, intracompany bank interest would be an exception to the proposed treaty's general preclusion of deductions for intracompany interest payments. Either country, under its respective internal laws, could, but is not required to, grant a deduction for interest paid on actual intracompany transactions. Rather than allowing deductions for such actual payments, the tax law of the United States determines the amount of deductible interest expense of a U.S. branch under the above cited regulations.

U.S. Senate Foreign Relations Committee Report on the 1992 U.S.-Mexico Income Tax Treaty and Protocol, Exec. Rep. 103-20, 93 TAX NOTES TODAY 241-42 (Nov. 26, 1993) (footnote omitted).

Second, with respect to interbranch interest, the United States has argued that its rules for determining the interest deduction available to foreign bank branches in the United States are consistent with its treaty obligations. Although the method for calculating the allowable interest deduction for a foreign bank's U.S. branch changed with the promulgation of new regulations in 1996, both the new and old regulations use a three step formula.²⁰³ First, the branch must determine the total value of all assets which generate income effectively connected with the conduct of the trade or business of the U.S. branch. Second, the branch must determine the amount of liabilities connected with its U.S. trade or business. This amount, however, is not an actual amount. It is calculated by multiplying the assets determined in the first step by either a fixed ratio of ninety-three percent for banks, or the actual worldwide liability to asset ratio of the entity. After having determined the total value of the U.S.-connected assets and liabilities, the final step involves calculation of the permitted interest deduction.²⁰⁴ On several occasions, the Service has ruled that the formula adequately compensates for the problems of taxing the branch on its net income while ignoring interbranch contracts.²⁰⁵ The Service also maintains that application of the allocation formula is consistent with the principles articulated in its tax treaties that require permanent establishments or branches of foreign corporations to be taxed as distinct and separate enterprises.²⁰⁶

Although this allocation method may produce more reasonable results than an approach that counted only existing third-party contracts entered into by the branch, it involves a formula based on factors other than the actual loans, liabilities, and interest rates of the branch and does not recognize the intra-bank transactions.²⁰⁷ Nonetheless, in the preamble to these new interest allocation rules, the Treasury and

²⁰³ See Treas. Reg. § 1.882-5 (1996). The new regulations were promulgated on March 5, 1996.

²⁰⁴ In this regard, the taxpayer has a choice between two methods: (1) the "adjusted U.S.-booked liabilities method," which uses a comparison of the branch's book liabilities (actual) and its liabilities calculated under step 2 (formula); and (2) the separate currency pools method which groups U.S. assets into different currency pools to determine liabilities and then uses worldwide interest rate averages for each pool. See Treas. Reg. § 1.882-5.

²⁰⁵ See, e.g., Rev. Rul. 89-115, 1989-2 C.B. 130, 130-31; Rev. Rul. 85-7, 1985-1 C.B. 188, 188-89.

²⁰⁶ See *id.* It is unclear whether the United States' position that its allocation formula for interest payments by bank branches of foreign entities is, in fact, consistent with its treaty obligations.

²⁰⁷ This formulary method raises a number of administrative concerns regarding the difficulty of obtaining data on a worldwide basis and has made the government hesitant to replace the arm's length approach with a formulary method of apportioning income. These concerns

the Service reiterated their belief that the allocation method is entirely consistent with treaty obligations.²⁰⁸ This position, however, may soon be tested in the courts. In 1995, a British bank filed a suit claiming that the business profits article of the U.K.-U.S. treaty permits a U.S. permanent establishment of a U.K. entity to calculate interest expense as if it were a separate entity.²⁰⁹

Finally, the United States has argued that its position on intra-bank interest payments is consistent with its general rules regarding the tax effect given transactions between different parts of the same entity. Taken literally, the U.S. position is correct to the extent that it claims to be consistent with the general view on nonrecognition of intra-taxpayer transactions. However, the analysis should not end there because the United States has not been consistent in applying this "general view," and because a different approach may be required in the case of bank branches operating in foreign countries.

As discussed in Part I, financial entities frequently operate in foreign countries in branch form, and often engage in interbranch instead of third-party transactions. Thus, sensible branch rules are necessary. Given that the United States is only taxing the profits attributable to the branch, in some basic sense it must look at the branch as an entity distinct from the rest of the corporation. This intuitive understanding can be expressed in more analytical terms. Although the branch does not have independent legal status, and is part of a single corporation with the home office, U.S. tax law draws certain legal distinctions between the branch and home office. In the cross-border context, the key distinctions are jurisdiction based; the United States can tax the branch, but not the home office, on a net basis.

To tax the branch fairly, the U.S. rules must account for the impact of these legal distinctions. Because of the scope of U.S. taxing jurisdic-

have led the New York State Bar Association to recommend that the fungibility approach be elective. See *NYSBA Report on Proposed Section 1.882-5* Aug. 26, 1992, 92 TAX NOTES INT'L 39-31 (Sept. 23, 1992). The ALI recommended a trading approach over a formulary one as its general rule for allocating deductions to the activities of a U.S. branch because of the administrative burden a formulary method places on the taxpayer to provide data and on the government to verify the information. See AMERICAN LAW INSTITUTE, *FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION* 117 (1987).

²⁰⁸ Preamble to Final Treasury Regulations § 1.882-5, 61 Fed. Reg. 9326 (1996) ("The IRS and the Treasury Department believe that the methodology provided in these regulations is fully consistent with all of the United States' treaty obligations, including the Business Profits article of our tax treaties.").

²⁰⁹ See Robert A. Katcher & Gary R. Vogel, *Interest Expense Allocation for Foreign Corporations: A Continuing Source of Discontent?*, 12 TAX NOTES INT'L 1551, 1553 (May 13, 1996) (describing the complaint filed in National Westminster Bank PLC v. United States, No. 95-758T (Fed. Cl. complaint filed Nov. 17, 1995)).

tion, it matters whether the branch or home office engages in a transaction. Thus, interbranch transactions are critical for locating income, gain, loss or deduction in the correct place. To the extent the United States fears abuse in the pricing of interest payments on interbranch loans, the concerns parallel those raised by parent-subsidiary transactions. In such cases, the United States recognizes the transactions and requires the transfer pricing between parent and subsidiary to be in conformity with market principles. The same principles could be extended to the recognition of intra-bank transactions.²¹⁰

Perhaps of greater significance in evaluating the U.S. consistency regarding intra-taxpayer transactions is the fact that the United States explicitly treats U.S. branches of foreign entities as separate entities for its own purposes.²¹¹ In addition to the basic income tax imposed on profits earned by a U.S. branch, the United States imposes a branch profits tax on foreign corporations engaged in a U.S. business.²¹² The branch profits tax is equal to thirty percent of the "dividend equivalent amount" for the taxable year.²¹³ The dividend equivalent amount is the "effectively connected earnings and profits for the taxable year" as adjusted by the statute, which can be roughly characterized as the U.S. branch's earnings that are not reinvested in the United States.²¹⁴

The purpose of the branch profits tax is to equalize the incentive of a foreign entity to conduct business in the United States in branch versus subsidiary form.²¹⁵ The provision seeks to accomplish this by achieving "greater parity between the remittance of [a foreign corporation's U.S.] branch profits and the distribution of [a U.S.] subsidiary['s] earnings."²¹⁶ If a foreign corporation engages in business in the United States through a subsidiary, the subsidiary would be subject to U.S. income tax on its earnings. The foreign parent then would be subject to U.S. tax on dividends paid by the U.S. subsidiary. If a foreign corporation operates in the United States through a branch, however, the foreign corporation is subject to tax on the U.S. branch's U.S. business profits, but no additional tax is imposed when those profits

²¹⁰ See *infra* Part IV for a discussion of the range of possible alternatives.

²¹¹ See generally Brown, *supra* note 7, at 194; Reich, *supra* note 7.

²¹² See I.R.C. § 884(b)(1) (1996); Treas. Reg. § 1.884-1(b) (1996).

²¹³ See I.R.C. § 884(a), (b).

²¹⁴ The first adjustment to earnings and profits is a reduction for the increase, if any, in U.S. net equity, i.e., investment in the United States. Certain other adjustments are also made under the applicable regulations. See Treas. Reg. § 1.884-1(b)(2), (3).

²¹⁵ See H.R. CONF. REP. NO. 99-841, at II-647 (1986), *reprinted in* 1986 U.S.C.A.A.N. 4075, 4735.

²¹⁶ See *id.*

are remitted or sent back to the home office.²¹⁷ For that reason, the branch profits tax was imposed to compensate for the fact that branches could otherwise remit funds to their home office free of an additional layer of tax.

By imposing the branch profits tax, the United States has implicitly recognized branches as entities separate from the home office.²¹⁸ Obviously, the United States does not consider legal status as a separate entity to be the sole criterion in tax.²¹⁹ Rather, in complex situations in which there is not only legal status to consider but also legal distinctions, a different compromise must be reached to accommodate the competing goals. The branch profits tax serves as such a bridge in the effort to coordinate tax objectives in a case in which legal status suggests different treatment for branches and subsidiaries, but the legal distinctions of jurisdiction prompt more comparable treatment. It is relevant to note that the branch profits tax was not conceived of as a penalty or response to abuse by taxpayers. The goal of the tax was to eliminate the difference between separately incorporating a U.S. business of a foreign corporation and maintaining it as a branch.²²⁰ Certainly, such an explicit and sweeping intention on the part of the

²¹⁷ Under certain conditions, the United States does treat a subsequent dividend by the foreign corporation to its shareholder as U.S. source, and thus subject to U.S. tax. Specifically, if 25% or more of the foreign corporation's gross income "for the 3-year period ending with the close of its taxable year preceding" was effectively connected with a U.S. trade or business, then a proportionate share of the dividend is considered U.S. source. I.R.C. § 861(a)(2)(B) (1996). This rule, however, poses difficulties to enforcement.

²¹⁸ See I.R.C. § 884(a) (1996); see also Brown, *supra* note 7, at 194.

²¹⁹ The tax treatment contemplated for the reverse case, a U.S. corporation with a foreign branch, demonstrates the range of branch rules Congress has been willing to consider. The 1954 Code passed by the House included a provision permitting a U.S. corporation to elect to defer income earned by a foreign branch until the income was withdrawn from the branch. See, e.g., Brown, *supra* note 7, at 159 n.146 (citing H.R. REP. NO. 83-1337, at 259-65 (1954)). The purpose, as with the branch profits tax today, was to achieve parity in the treatment of subsidiaries and branches—in this case between U.S. corporations and their foreign branches and subsidiaries. See *id.* As part of this deferral, the branch income was to be separately calculated and interbranch transactions recognized. See *id.* For reasons concerning a related provision, however, this branch rule was not included in the Senate bill, and ultimately, both provisions were dropped in Conference Committee. See *id.* (citing S. REP. NO. 83-1622, at 105 (1954) *reprinted in* 2 U.S. Revenue Acts, 1954 Legislative History & Congressional Documents; H.R. Rep. No. 83-2543, at 68-69 (1954), *reprinted in* 2 U.S. Revenue Acts, 1954 Legislative History & Congressional Documents).

²²⁰ In addition to the branch profits tax, the United States imposes a branch level interest tax that requires a foreign corporation to pay tax on certain amounts of "excess" interest that its branch pays. This arises in certain situations in which the branch is permitted a deduction for interest payments and the foreign home office is subject to tax as if it were the recipient of the interest. See I.R.C. § 884(f) (1996).

United States to view and to tax branches like subsidiaries cannot be dismissed as a minor inconsistency. Instead, it is a powerful example of the real similarity between branches and subsidiaries, as well as the government's comfort level in adopting that position.

Certain provisions in the foreign currency transaction rules also treat branches as having a role separate from the home office (or other branches).²²¹ First, the core concept in the foreign currency regime of "functional currency" (the primary currency in which the business is conducted) is determined not on a corporation-wide basis, but on a business unit-(i.e., branch) by-business unit basis.²²² Second, even though the foreign currency rules generally do not recognize interbranch transactions, they do recognize transfers that change the functional currency of an item.²²³ If a French branch transfers a yen liability to a Tokyo branch, the transaction may be recognized by the foreign currency rules.²²⁴ The provisions can be understood as an effort to incorporate the effect of both economics (common ownership) and legal distinctions (functional currency).

In addition to using the independent status of branches in the branch profits tax and foreign currency rules, the Code has looked beyond strict legal status in other provisions. For example, regulated investment companies ("RICs"),²²⁵ which pursuant to a special regime are generally taxed as pass-through entities,²²⁶ are permitted to engage in recognized self-dealing. If an investment company that qualifies as an RIC wants to offer several different funds with different investment strategies, it has a choice. First, it can set up a separate RIC for each fund. Alternatively, it can form a series fund, a single corporation comprising multiple funds with separate classes of beneficial ownership that effectively allow investors to own the fund of their choice.²²⁷ The series fund approach can be preferable because of savings in

²²¹ See *id.* §§ 985-989 (1996).

²²² See *id.* § 985(b)(1).

²²³ See Treas. Reg. § 1.988-1(a)(10)(ii) (1992).

²²⁴ See *id.*

²²⁵ RICs are domestic corporations or business trusts registered as investment companies with the Securities and Exchange Commission under the Investment Company Act of 1940, that make an election and satisfy asset and income tests. See I.R.C. § 851(a), (b) (1996).

²²⁶ Qualifying RICs can deduct the amount of ordinary dividends paid from the calculation of investment company taxable income. See *id.* § 852(b)(2) (1996).

²²⁷ See *id.* § 851(h)(2) (defining a series fund as a "segregated portfolio of assets, the beneficial interests in which are owned by the holders of a class or series of stock of the regulated investment company that is preferred over all other classes or series in respect of such portfolio of assets").

formation costs, shareholder report preparation costs, filing fees, directors' fees, custody fees, and auditor fees.²²⁸ Each fund is considered a separate corporation for tax purposes, thus, transactions between funds of a single RIC constitute recognized, taxable events.²²⁹

The parallel between an RIC series fund whose different funds deal with each other and a corporation whose foreign branch and home office engage in interbranch transactions is twofold. On a simple level, both involve a single legal entity whose subdivisions engage in transactions with each other as if they were third parties. The acceptance of these transactions within the RIC is another example of legal status not being determinative of tax treatment. On a more complex level, the recognition of RIC interfund transactions can be understood as a balance between the factors of legal status and economic ownership. Legal status would dictate non-recognition for these interfund contracts because the RIC is a single corporation. However, economic ownership points in the other direction. The fact that an RIC series fund can have different shareholders owning the different funds means the RIC lacks the common economic ownership that usually bars the recognition of intra-taxpayer transactions. In this balance of legal status and economic ownership, the factors support allowance of inter-fund contracts.

Similarly, in the context of interbranch contracts, a balance of different factors supports recognition. The central issue in the taxation of interbranch transactions (as well as related party transactions) is the integration of the three factors: legal status (incorporation), economic ownership, and legal distinctions (e.g., source and jurisdiction, accounting method, and functional currency). With respect to interbranch transactions, although the first two factors often appear to support nonrecognition, the last factor, legal distinctions, can be strong enough to require that interbranch transactions be recognized. Thus, an understanding of the treatment of RICs, which demonstrates that legal status is not determinative and that the tax system has the ability to assess the relative importance of each factor in a given case, offers

²²⁸ See Richard M. Hervey, *Taxation of Regulated Investment Companies*, 740 Tax Mgmt. (BNA) at A-107 (1995).

²²⁹ See I.R.C. § 851(h)(1). Prior to 1986 when § 851(h) was added to the Code, a series corporation was considered a single taxpayer and no gain or loss was realized on the transfer for cash of securities from one portfolio (fund) in the corporation to another. See *Union Trusteed Funds, Inc. v. Commissioner*, 8 T.C. 1133, 1137 (1947) (single entity treatment), *acq. in result*, 1947-2 C.B. 4; Rev. Rul. 56-246, 1956-1 C.B. 316 (asset transfers), *declared obsolete in* Rev. Rul. 88-14, 1988-1 C.B. 405 (due to the enactment of § 851(q)).

an additional perspective on the analysis of risk-shifting through interbranch contracts.

D. Observations from the Comparison

The comparison between interbranch and related party transactions illustrates some general points as well as some specific observations. First, although the United States does have a principle, based in part on common sense, that a taxpayer cannot contract with itself, the position is not absolute. The principle is not strictly followed because it emphasizes only one of three relevant factors (legal status) and ignores the other two (legal distinctions and economic ownership). The basic related party rule reflects acceptance of legal status as a key factor, but acknowledges the importance of common economic ownership through its reliance on anti-abuse provisions such as §§ 267 and 482 of the I.R.C.

Consolidated group hedging rules display an even more sensitive (though still limited) approach. Where common economic ownership seems to dominate legal status and/or legal distinctions, the consolidated group is treated as a single corporation and a third-party position held by one member of the group can be hedged for tax purposes by another member. If legal status and legal distinctions seem to weigh heavily, however, the member's separateness is emphasized and any inter-member hedging contracts are recognized under the separate entity election.

Interbranch contracts raise the same questions. The only difference is how the factors balance. Instead of legal status supporting recognition of interbranch transactions, it is the importance of the legal distinctions which compels adequate attention to interbranch contracts.

IV. ALTERNATIVE TAX TREATMENTS FOR RISK-SHIFTING WITHIN A CORPORATION

As the technical review of current law in Parts I and II and the legal analysis in Part III demonstrate, the tax system struggles in its effort to tax risk-shifting appropriately within a single corporation. Better rules are essential for businesses that frequently rely on interbranch transactions to conduct business, such as financial entities using interbranch hedges. The tremendous increase in the globalization of financial markets has expanded the role of financial intermediaries and the volume of their transactions. Under such circumstances, tolerance for uneconomic taxation of branch income is limited and

the scale of the problem is increasing. What is needed are tax rules on risk-shifting that do not change taxpayer behavior and do not create a tax effect for transactions (such as hedges) that have a net zero economic impact. The analysis in Part III sought to examine why the current rules are inadequate and how the tax rules for related party risk-shifting manage comparable tensions. The analysis ultimately focused on three factors—legal status, legal distinctions, and economic ownership—and reviewed their relationship.

Part IV begins by building on the determination that complete dependence on legal status as a fundamental tax principle fails to incorporate the incentives and economic realities of common ownership and the impact of legal distinctions. The U.S. tax system has demonstrated the most flexibility in coordinating these factors in the treatment of separately incorporated related parties, by providing single and separate entity hedging regimes for consolidated groups. Treating members of a consolidated group as divisions of a single corporation reduces reliance on legal status and implements rules that better reflect taxable income and underlying activity.²³⁰ The related party cases highlight some elements useful in assessing alternative branch tax rules, including: willingness to look beyond formal status, use of anti-abuse rules, reporting requirements, limited scope for new rules, and the acknowledgment of dual relationships (e.g., in the parent-subsidiary context some interactions and transfers, such as dividends and contributions to capital, reflect the shareholder-corporation relationship while others are essentially equivalent to third-party transactions).

Part IV synthesizes the observations developed in Parts I, II and III into recommendations for new branch rules. Given the virtual inevitability of legal distinctions such as jurisdiction, and their impact on domestic and foreign taxpayers, issues of branch taxation and internal risk-shifting must be resolved. Success is measured by identifying rules that have minimal impact on taxpayer behavior and that do a better job of reconciling the three factors than the current rules.

²³⁰ Economic ownership, however, is not an all or nothing factor and these examples raise additional questions about where to draw the ownership line in rules that rely on this factor. For example, the consolidated group rules operate on a defined set of taxpayers, those constituting a consolidated group with 80% or more common ownership. Given that the degree of common ownership and its relevance moves along a sliding scale, starting with 100% common ownership (e.g., parent and subsidiary) and moving down, the task is to determine how to incorporate the basic factor into a specific rule, such as the level of common ownership needed to qualify for consolidation. The intangible and imprecise nature of the economic ownership factor is perhaps better reflected in the allocation and pricing rules of § 482 of the I.R.C., which speak in terms of "control," a term defined broadly in the regulations. I.R.C. § 482 (1996); Treas. Reg. § 1.482-1(i)(4), (5) (1994).

Explicit recognition of interbranch transactions is viewed as a likely but not exclusive recommendation because this paper seeks a full analysis of the taxation of risk-shifting.

The question, therefore, is what alternatives can and should the United States consider for branch taxation. At least six possibilities can be outlined, which differ on several levels, including: (1) scope of coverage, (2) process used, (3) role of the taxpayer in obtaining the tax treatment, (4) degree of interaction with other countries, (5) cost of obtaining the treatment, (6) degree of remaining uncertainty and risk for both the taxpayer and the government, and (7) permanence of the rule. Each of the possible approaches is explained and evaluated below in sections A through F. Finally, in section G, their comparative advantages are considered.

A. Individualized Taxation: Advance Pricing Agreements

The absence of an immediate regulatory response to the problematic taxation of interbranch transactions has pushed taxpayers towards less direct resolutions. Having failed to persuade the United States to change its policy or "reinterpret" its treaties, taxpayers have sought other avenues toward the same results. The primary mechanism has been the use of APAs. The APA procedure was formally introduced in 1991.²³¹ The procedure permits a multinational taxpayer to approach the Service (and other countries simultaneously) and develop an intercompany pricing and cost sharing methodology that will be applied prospectively (and in some cases, retrospectively) to its transactions.²³² The procedure was an outgrowth of increasing audits and litigation over transfer pricing under § 482 of the I.R.C. and was intended to limit audit risks and costs for both the government and taxpayers. If the taxpayer complies with the terms of its negotiated APA and provides the supporting documentation during the period for which the APA applies, then the Service's audit of the transactions will be more limited in scope.

Although the APA process was not specifically designed to mediate interbranch tax issues, a number of major financial entities have sought or are seeking APAs, in part to deal with problems caused by the U.S. position on interbranch contracts. The initial wave of APAs confronting the interbranch issue resolved it through a negotiated

²³¹ See Rev. Proc. 91-22, 1991-1 C.B. 526, 527.

²³² The Service recently issued Rev. Proc. 96-53, 1996-49 I.R.B. 9-20, which supersedes Rev. Proc. 91-22 and updates the procedures for obtaining an APA.

formulary method of attributing income and expense to the various operations of the taxpayer.²³³ Interbranch transactions were not explicitly recognized, but were accounted for by trying to reflect the value attributable to that segment of the corporation.²³⁴ The Service has since determined that it has the authority to recognize interbranch transactions pursuant to the mutual agreement provisions of its income tax treaties.²³⁵ The first APA directly covering the taxation of cross-border interbranch transactions was completed in early 1995.²³⁶ In the absence of a treaty, however, there is no basis for recognizing interbranch contracts because the authority for such APAs derives from treaty provisions.²³⁷

Under the current tax regime, APAs are the only framework for recognizing interbranch transactions, and even then only in a limited context. The taxpayer must be engaged in cross-border transactions in a treaty country, and the Service (and other countries) must agree to the methodology proposed by the taxpayer. Certainly, for taxpayers facing significant interbranch issues, obtaining an APA is a valid and serious alternative. The question, however, from a systemic point of view is whether this "solution" is adequate. If it is, then the Service could follow its current course which would allow it to maintain its formal position of nonrecognition of branch transactions while gradually gaining detailed information about business interbranch practices. To the extent that most of the interbranch-motivated APAs involve financial institutions, the Service may be able to devise a satisfactory standardized procedure for the industry.²³⁸

Pursuing a more process-oriented approach, like APAs, may be desirable on strategic grounds. If the United States were to adopt new substantive branch tax rules unilaterally, it would forego the opportu-

²³³ See Notice 94-40, 1994-1 C.B. 351, 352 (general guidance for submitting APA requests regarding global trading).

²³⁴ See *id.*

²³⁵ See *First APA Covering Cross-Border, Interbranch Bank Transactions Concluded*, 1995 DAILY TAX REP. at 45, d3 (March 8, 1995) (the use of APAs for interbranch transactions became possible when, in 1994, the Service concluded that it had the authority to do so pursuant to its treaties).

²³⁶ See *id.* (noting that the Service had concluded its first APA for the allocation of income from interbranch financial products transactions).

²³⁷ See *id.*

²³⁸ See, e.g., I.R.S. Notice 94-40, 1994-1 C.B. 351, 352 (providing a summary and review of APAs for global trading operations); see also *Bilateral APA for Interbranch Foreign Exchange Transaction*, 66 TAX NOTES 1607 (March 13, 1995) (noting that the Director of the Service's APA program indicated that the next step would be to release "general guidance for submitting APA requests" on interbranch contracts, similar to the guidance provided in Notice 94-40).

nity to gain something in return through a negotiated procedure, such as an APA or treaty. The same argument has been made in favor of keeping the statutory withholding rate on dividends and royalties at thirty percent and relying on treaty negotiation to provide a lower rate.²³⁹ However, even if such a strategic opportunity were lost by a decision to take a substantive route on interbranch contracts, there might be a significant difference between using this leverage argument for withholding rates and using it for substantive questions of tax law that directly impact the taxation of economic income. Moreover, reduction of withholding rates is more clearly a direct revenue loser for the United States for which it would like an offsetting concession. Conversely, improving the interbranch statutory rules would, in many cases, simply decrease the random nature of taxable gains and losses from hedging transactions in comparison to the economic gains and losses.

Unfortunately, the APA solution is not an institutional response to a problem with the tax law, but rather an alternative by which a taxpayer can achieve a result different from the one prescribed by current law. The taxpayer must undertake the intensive APA process in order to resolve what here is argued to be arbitrary tax treatment of interbranch transactions. Although compelling interim needs may make this approach currently necessary from both the government and taxpayer perspectives, we should not be satisfied with this as a permanent resolution of the interbranch question. Regardless of the basic concerns over APAs (including their private law nature and limited availability), we should be hesitant to allow the flexibility available through these contracts to justify not confronting problems with the substantive law.²⁴⁰ Moreover, although APAs may be a good device for monitoring smaller numbers of taxpayers, large scale application of the APA process may be more limited.

²³⁹ See, e.g., AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II 13 (1992). Noting that:

some tax administrators have explicitly acknowledged the practice of adopting domestic law rules designed to be modified by treaty (most frequently by imposing withholding tax rates higher than deemed appropriate in order to use a reduction in those rates as a "bargaining chip" to bring potential treaty parties to the negotiating table.

Id.

²⁴⁰ See, e.g., Mike McIntyre, *The Case For Public Disclosure of Advance Rulings on Transfer Pricing Methodologies*, 91 TAX NOTES INT'L 2-27 (Jan. 9, 1991) (describing various drawbacks of the APA process).

B. *Tracing Third-party Contracts*

To the extent the United States considers making substantive law changes to branch taxation, a range of options are available. The most conservative new rule would follow a tracing approach. Branches would be allowed to treat as their own transactions those third-party contracts entered into by the home office (or other branch) that were identified as entered into on behalf of the branch. Essentially, the home office (or other branch) would operate as an agent for the branch. A tracing method differs from a strict separate entity approach because it does not incorporate a profit element.²⁴¹ For example, in determining expense deductions for a U.S. branch of a foreign corporation, tracing would impute a charge to the branch equal to the cost of expenses, whereas separate entity treatment would include a profit element in the charge.²⁴²

Unlike the use of APAs, this approach relies on the tax law to confront the problem and propose a universal solution. But in theory and practice it proves to be a limited approach. First, it is unclear how one part of a single taxpayer can be an agent for another part of the taxpayer in a regime that does not acknowledge any significant independent function of branches in the tax law. It may be necessary in this line of argument to envision the "agency" idea as a shorthand for identifying what is "allocable" to branch activities, that is, identifying which contracts should be on the branch's books.

Second, and more importantly, this method only works to the extent that discrete home office contracts with third parties correspond to branch activities (and there is no net hedging). Typically, it may not be theoretically accurate nor administratively feasible to match interbranch and third-party contracts on a one-for-one basis.²⁴³ To rely

²⁴¹ See generally Commentary to 1992 OECD Model Treaty, art. (7)(2) ¶¶ 17, 17.1 (March 1994) (noting that the treatment of the profit element is the major difference between the provisions of the Model providing for recognition of interbranch transactions and those that permit tracing).

²⁴² See, e.g., Brown, *supra* note 7, at 172 (describing the different treatment of profits under tracing and separate entity approaches).

²⁴³ A related observation has been made in the context of § 475 of the I.R.C. regarding the taxation of dealers. There it has been noted that a "banking unit hedges its aggregate risk by transferring it to the derivative dealer unit by means of an interdivisional hedging transaction" and that the "dealer unit does not generally hedge the banking unit's risk by entering into specific third-party contracts Instead the dealer unit aggregates the banking unit's risk with [others] and hedges only the resulting net risk." Letter to Treasury from Thomas A. Stout, Jr. dated Sept. 15, 1994, reprinted in 94 TAX NOTES TODAY 211-33 (Oct. 27, 1994) (citing H.R. CONF. REP. NO. 103-213, at 615 (1993), reprinted in 1993 U.S.C.C.A.N. 1088, 1304, which acknowledged that taxpayers with such a hedging strategy often use accounting systems that clearly identify these

on a tracing rule to gain recognition of interbranch contracts, taxpayers would need to modify their business practices and facilitate one-for-one matching by eliminating any net hedging and maintaining a record of the correlation. Tracing meets certain tax goals by quantifying the activity of the different branches of an entity, thereby providing a more accurate measure of taxable income. Its limited proxy function, however, increases transaction costs by modifying business behavior and by reducing the effectiveness and realistic availability of such a rule.

C. *Limited Recognition of Interbranch Contracts*

Another approach for addressing the interbranch issue through changes in the tax law would be to recognize a limited class of interbranch contracts. The most likely class would be interbranch contracts of financial institutions, because of these taxpayers' extensive use of the branch form and interbranch contracts. The shift to this rule would signal that legal status is not the only factor and that legal distinctions and economic ownership are also significant. Unlike a tracing rule, it would send this signal more effectively by actually recognizing the interbranch contract. In addition, it would make the relief more readily available by directly using the interbranch contracts, rather than using a proxy that is imperfect due to its limited correlation to the interbranch contracts.

What needs to be explained and justified is the limited scope of such a rule. Why recognize some interbranch contracts, but not all? Why the contracts of financial institutions but not other taxpayers? Clearly it is a "partial" solution which draws lines not required by the analysis of the three factors underlying these transactions (legal status, legal distinctions, and economic ownership). The rationale for offering a limited interbranch method is that it responds to administrative and implementation concerns by initiating change in a more controlled environment. The approach shares some of the appeal of the APA method, which is praised as a mechanism that allows the Service to move more slowly and gather information by negotiating branch rules on a case-by-case basis. Both the limited recognition rule and the APA

transactions between the business units and handle them like transactions between unrelated parties). Based on this picture, it has been proposed that a portion of the dealer hedge with third parties be considered the hedge of the banking unit and that this can be achieved by relying on the amount of income or loss the banking unit should recognize from the interbranch hedge. *See id.*

process offer the U.S. tax system some protection against interbranch abuse in unanticipated contexts.

This same virtue may pose a problem as well because it requires identification of a clear rationale for limiting the scope to financial institutions. Applying the rule to only financial institutions can be justified by focusing on taxpayer need, risk containment, and administrative concerns. As discussed earlier, financial institutions frequently operate in branch form and often engage in interbranch transactions as part of their regular business patterns. To the extent the failure to recognize interbranch contracts and internal risk-shifting results in serious distortions in taxable income and taxpayer behavior, any solution should be directed first toward those taxpayers who bear the brunt of the problem. Of course, restricting the rule to financial institutions puts pressure on the definition of such entities. Taxpayers seeking recognition of interbranch transactions might strive to characterize themselves as within the scope of qualified entities. Classification of taxpayers and the problems it poses are not new, however, and should not be a major barrier to considering a limited recognition rule.

Initial reliance on a limited recognition rule for financial entities can also be supported by the desire to contain risk and to facilitate successful implementation of the rule. Any unanticipated risks that the government may face by changing its position on branch transactions without the benefit of *ex ante* individualized review (as in APAs) is minimized by the composition and limited size of the pool of taxpayers able to avail themselves of the new rule. The government, which has been gathering APA information on interbranch contracts of financial entities, would have the opportunity to see the ramifications of a recognition rule play out among the financial institutions before introducing the rule to taxpayers generally. Such a "contained" approach eases the government's administrative burden. The volume and variety of taxpayers to be evaluated under the limited recognition rule are less than that which would result from a broader introduction of interbranch contract recognition.

Characterizing and justifying a limited recognition rule in this way indicates that ideally its status is temporary and that when the government has gained sufficient experience to satisfy concerns regarding unanticipated impacts, the scope of recognized interbranch transactions would be broadened. Although this is a plausible path, the necessity of pursuing the intermediate course of a limited recognition rule may be negated by the existing APA process. To the extent the current use of APAs among financial entities (as well as other taxpayers) has already provided the Service with significant data on inter-

branch transactions and risk-shifting within a corporation, it may have served the function of a limited recognition rule. In that case, little additional benefit might be gained by taking an interim step, unless the Service believes that for reasons of administrability, the potential risks can be contained only by limited application.²⁴⁴

D. *General Recognition of Interbranch Contracts*

The prior alternatives have been described against the backdrop of the "ultimate" rule that could be adopted: general statutory recognition of interbranch contracts.²⁴⁵ The rationale for broad recognition of interbranch contracts is the same one that motivates the first three approaches described: a determination that the current tax system's almost exclusive reliance on legal status with respect to interbranch contracts fails to adequately address the impact of legal distinctions, and thus produces distortions in taxable income. Taking the recognition of interbranch transactions, this extra step eliminates the issues raised with the third approach (limited recognition rule) regarding its more narrow scope.

General recognition, however, raises the specter of unanticipated abuses. The problem may be most serious in cases where interbranch contracts are not regularly used and thus have not been explored yet in an APA negotiation. For example, if most APA interbranch discussions have involved financial entities whose regular business structure includes interbranch contracts, then the APAs may not have gathered sufficient information about the use of interbranch contracts in other settings. This observation, however, does not necessarily guide the choice of rule here. First, it assumes that there is in fact a serious difference in the potential abuse of interbranch contracts in nonfinancial settings. But if there are ways in which interbranch contracts can be used inappropriately, financial entities are just as capable of making that discovery. Moreover, it would be easier for a taxpayer with many valid interbranch contracts (such as a financial entity) to disguise an inappropriate one, than it would be for a taxpayer that engages in the transactions less frequently.

In addition, if a limited recognition rule is considered preferable, in part because it offers the Service more time to study the use of

²⁴⁴ The one additional benefit from adopting a limited recognition rule would relate to cost. Any taxpayer entering into APA negotiations solely to obtain recognition of interbranch contracts would find a statutory recognition rule a much cheaper route.

²⁴⁵ See generally Brown, *supra* note 7, at 136 (advocating application of the separate entity approach only to U.S. branches of foreign corporations).

interbranch contracts, it is unclear how the extra time would help. If what is needed is information on how nonfinancial sector taxpayers use interbranch contracts, then more data on financial taxpayers is not particularly useful. If the limited recognition rule is valued for its risk containment, however, then it could be a sensible interim step if APAs are providing the Service with sufficiently comprehensive data on the general use of interbranch contracts.

To the extent the major hesitation in recognizing interbranch contracts derives from a concern about abuse, it is useful to consider what the sources of such abuse might be. Potential pricing and timing games would necessitate rules paralleling the related party provisions (§§ 267 and 482 of the I.R.C.). Such branch anti-abuse rules would face the same design and administrability questions that challenge §§ 267 and 482. Assuming, however, that comparable results can be achieved from these anti-abuse rules in the branch context, the remaining risks lie beyond simple timing and income location maneuvers.²⁴⁶ Risk possibilities may develop in the interaction of specific rules that classify income and assign importance to that classification. Other opportunities for abuse may derive from the interaction of tax and regulatory law. Many of the same risks exist in related party transactions, and the Service's experiences there, as well as in the APA treatment of branch transactions, should provide an adequate foundation for recognition of interbranch transactions without risking wholesale abuse.

A related issue, which does not involve abuse per se, raises questions about the Service's capacity to monitor taxpayer transactions. The issue is the coexistence of two different kinds of transfers between the relevant parties, either subsidiary and parent or branch and home office. The first kind of transfer is the arm's length transaction, such as a swap, that has been the focus of this paper. This transaction's recognition and taxation is important to a more sensible allocation and calculation of taxable income. The second is a special relationship transaction that depends on the shareholder or branch status. Examples include contributions to the capital of the corporation or transfers from the home office to the branch as funding capital.

Distinguishing between the two categories depends on a variety of factors such as the nature of the transfer, reciprocity, reporting in the books and records, contemporaneous identification, and whether the transaction is of a type entered into with third parties. Again, the

²⁴⁶ See *supra* text accompanying notes 58–188.

experience with both related party transactions and APA branch cases makes the foray into these distinctions less novel in the interbranch context. Nonetheless, concern about abuse is not unwarranted and parallels to related party transactions may not be entirely satisfactory, especially if the difference in legal status between branches and subsidiaries affords branches greater opportunities for strategic behavior. The choice of rule for interbranch contracts depends in part on an assessment of the similarity of interbranch and related party transactions, the degree of risk under different regimes, and the value of data collected on both related party contracts and APA treatment of interbranch contracts.

E. *Interbranch Election*

Another statutory option for recognizing interbranch contracts would be to establish an election for interbranch treatment. The question here would be what benefits derive from making the tax treatment elective. First, the elective approach may be preferable because if it leads a few, but not too many, nonfinancial sector entities to pursue recognition, the Service would have the opportunity to expand its understanding of interbranch contracts.

Second, depending on how broadly interbranch transactions are defined, some taxpayers might prefer nonrecognition of interbranch transactions. Taxpayers who perceive themselves to be operating as single entities and for whom interbranch transfers do not play a significant role in the calculation of branch taxable income might find it inconvenient to keep track of interbranch transactions (as well as to monitor them for arm's length pricing). This scenario is most probable where the interbranch transactions are not of the type normally entered into by the taxpayer with third parties. For such taxpayers, an election into (or out of) interbranch recognition may permit the flexibility needed to accommodate the impact of legal status, legal distinctions, and economic ownership. This rationale for an election was the premise underlying the new consolidated group hedging rules which allow either single or separate entity treatment of the group.²⁴⁷

Here, however, as in the consolidated case, there remains the question of whether an election should be on an entity or a transaction basis. If there are some interbranch contracts which are not in the special relationship category (of, for example, a contribution to capital), but also do not need to be recognized for sensible taxation, then

²⁴⁷ See *supra* text accompanying notes 141-50.

the flexibility of an election may be useful. On the other hand, an election may increase the government's monitoring costs as well as the opportunity for abuse. Under those circumstances, the practical response and compromise might be to grant the election only on an entity basis.

Despite the analysis above, the value of an election is questionable on several grounds. First, if the election is entity-wide, so that the real choice is between subsidiary-like treatment of interbranch transactions and traditional nonrecognition, that choice is *de facto* available on an elective basis to the taxpayer through the decision to operate through a branch or through a subsidiary. If the choice is already available through the incorporation decision (or through an election under the new classification rules), an additional opportunity for choice may be an unwarranted complication of the system.²⁴⁸ However, placing the entire burden of resolving internal risk-shifting problems on the choice to incorporate fails to account for the multifaceted nature of the decision to incorporate. For example, as described earlier, financial institutions have powerful operating and regulatory incentives to use the branch form. Even if incorporation of the branch resulted in tax treatment more reflective of the underlying transactions, incorporation might carry too great a regulatory burden. A tax election would accommodate these factors.

The practical value of an election is also questioned by a comparison with the limited recognition rule. Given that most financial entities likely would make an election, and that many other entities might not (because the record keeping requirements might outweigh the benefit), it is not clear that the results under an election rule would vary from the third approach (limited recognition). If that prediction is accurate, the choice between an election approach and a limited recognition rule turns on an assessment of the costs of each method. Limited recognition would increase debate over which entities qualify for recognition. An election procedure would raise questions about effective elections; in addition, it would broaden the range of taxpayers potentially choosing interbranch recognition to beyond those with which the Service has had experience through the APA process. These costs must be compared with the possible benefits including flexibility, limited risk for the government, and the opportunity to gather information.

²⁴⁸ See *supra* text accompanying notes 121–22.

F. *Treaty Recognition of Interbranch Contracts*

A final, non-statutory approach to recognizing interbranch contracts would be to recognize them only through treaties. In this context, treaty-based recognition means drafting a treaty article that grants recognition of interbranch contracts to taxpayers entitled to the benefits of the treaty. Unlike the current APA process which relies on the treaty mutual agreement provision and which requires government negotiation on a case-by-case basis, a specific treaty article would enable taxpayers to avail themselves of branch recognition by direct reference to the terms of the treaty.

A specific treaty article could be preferable to the statutory alternatives outlined above. Both enable the taxpayer to recognize interbranch contracts for tax purposes without further government involvement; no permission or negotiating is required. However, the United States may gain a strategic negotiating advantage by inserting an interbranch contract provision into a treaty instead of into a statute. A branch rule drafted as a statute or a regulation is a unilateral act. The benefits are available to taxpayers from all countries without any concessions having been secured in return. In contrast, if the branch rule is part of treaty drafting, then the United States can use it in the bargaining process to extract a favorable provision for U.S. residents.²⁴⁹

In addition to enhancing the U.S. negotiating position, use of a treaty provision may limit the number but not necessarily the range of taxpayers having their branch transactions recognized. Thus, the Service could have exposure to a variety of interbranch contracts without the administrative burden and risk of a broad statutory recognition rule. Even if the United States later enacted a statutory rule allowing recognition of interbranch contracts, taking the initial steps through the treaty process would give the Service a buffer period to gather information. During the time that interbranch contracts are recognized only by treaty, however, recognition is limited to those transactions involving a treaty country. This is the same situation currently facing taxpayers under the APA process.²⁵⁰ Interbranch contracts are recognized only through the mutual agreement provision. Thus, an applicable treaty is necessary to get the Service to recognize the contract. A comparable transaction undertaken in a non-treaty country will not be recognized by the Service.

²⁴⁹ See *supra* text accompanying note 239.

²⁵⁰ See *supra* text accompanying notes 235-37.

A more serious problem with the treaty approach is a practical one. Treaty negotiation can be a slow and complicated process. The APA reliance on treaties' mutual agreement provisions was implemented immediately because it involved interpretation of an existing article. However, reliance on a new interbranch provision would have to await the actual negotiation and approval of new treaties. Although once the provision was in place a taxpayer could more easily obtain benefits through a treaty interbranch article than through an APA, the mutual agreement provision underlying the APAs is available now. Moreover, as discussed earlier, resolving significant issues of branch taxation through a bilateral or multilateral process, rather than through a unilateral statutory change, may make the availability of the remedy too uncertain.

G. Summary

The recommendations outlined above do not include an apportionment formula for several reasons. First, a formulary approach is excluded (except to the extent some version is used in an APA) because an arm's length method should be fairly successful with the transactions under review—interbranch contracts that are comparable to third-party contracts, and are often financial ones for which market quotes should be readily available. Second, avoidance of double taxation under a formulary approach may be more difficult because other countries have significantly differing ideas of what constitutes the correct formula.²⁵¹ Finally, most countries have given a cool reception to the suggestion of adopting a formulary approach in place of an arm's length standard.²⁵² California's experience with the unitary method

²⁵¹ See, e.g., Plambeck, *supra* note 15, at 1156 (noting the difficulties in "reaching agreements as to the apportionment factors").

²⁵² The 1996 IFA Congress, in considering the taxation of permanent establishments of banks, insurance companies, and other financial services entities, which "are often subject to high levels of regulation that conflict with tax law," endorsed the direct method for allocation of income and capital based on branch accounts and rejected the indirect (formulary) method. Albertina M. Fernandez, *50th IFA Congress Gets Underway in Geneva*, 13 TAX NOTES INT'L 860 (Sept. 9, 1996). The resolution adopted by the Congress states:

Allowing for the extended functional independence of permanent establishments of banks and insurance companies, the capital endowment of the branch in accordance with the regulatory requirements has to be respected by the relevant tax authorities. Any exceeding amount should be respected as a loan granted by the head office to the branch 'or' additional equity depending on the head office's valid commercial intention, since it must be at the head office's entrepreneurial discretion to vest the branch with any amount considered necessary to conduct the branch-specific business line.

demonstrated the international controversy that a formulary approach can generate.²⁵³

Therefore, in considering the future direction of branch taxation, the six alternatives outlined above capture the spectrum of choices that are likely available. These six rules do not exhaust the possibilities, and in fact it is easy to envision rules that combine attributes of two or more, such as an interbranch election for financial entities, or a short-form APA for interbranch contracts of financial entities. In focusing on the basic six possibilities, however, preference for a given rule depends on the analysis and relative weight of certain factors.

The factors driving the choice can be grouped into two basic categories: those that emphasize the impact of the rules on taxpayers and those that emphasize the administrative concerns of the Service. In the first category, the factors include: (1) concern for nonfinancial entities' interbranch contracts; (2) need for more widely and immediately available relief; and (3) flexibility for taxpayers in different factual circumstances. If few nonfinancial entities have a serious interbranch problem, then a limited recognition rule may be acceptable. Conversely, if expanding taxpayer access to interbranch recognition is critical, the general recognition or election approach would be preferable. If the key is time, a treaty or APA approach would be unattractive because of the delay under each.²⁵⁴ Instead, any of the other four approaches would be better in terms of their immediate availability, although the scope of coverage of taxpayers and transactions would vary. If flexibility is sought for taxpayers, an election would be more desirable than a single statutory rule (e.g., tracing, limited recognition, and full recognition) and an APA or treaty approach might be an adequate alternative.

In the second category, which focuses on administrative concerns, the factors include: (1) need for more data on financial entities; (2) need for more data on nonfinancial entities; (3) likely sources of more

Id. The Congress also encouraged revision of the OECD guidelines for allocating income from loans: "Allowing for the functional independence of the branches of banks and insurance companies, the transferability of loans should be recognized for taxation purposes if valid commercial reasons can be given for such transfer 'or' if the same transfer would have been effected between unrelated third parties." *Id.*

²⁵³ See, e.g., J. Dwight Evans, *With Barclays and Colgate Settled, Worldwide Formulary Reporting Goes Federal*, 94 TAX NOTES TODAY 200-118 (Oct. 21, 1994) (noting the concern of the United Kingdom and numerous other foreign governments over California's use of worldwide apportionment); Samuels & Brown, *supra* note 7, at 600 (describing some difficulties California encountered with its unitary tax).

²⁵⁴ For APAs the time consuming element is the individual negotiation process (which can take time and money); for treaties, it is the country-level negotiation.

information; (4) value of increased treaty bargaining power; (5) preservation of government's future flexibility; (6) risk of abuse from too many taxpayers using interbranch contracts; (7) risk of abuse from nonfinancial entities using interbranch contracts; and (8) nature of information obtained from the APA process.

If more data is needed on financial entities' use of interbranch contracts, then a conservative approach, either the continued APA approach or a limited recognition rule, might meet this need by restricting the taxpayers for whom interbranch recognition would be available until the Service had the opportunity to gather adequate data. Alternatively, if the information needed concerns how nonfinancial entities use interbranch contracts, then the limited recognition rule would be ineffectual because it would only allow financial entities to have recognized interbranch contracts. An APA approach might be useful if nonfinancial taxpayers are using the process for their interbranch contracts.

In all of these considerations, potential sources of new information are central. If APAs are a valuable resource, continuation or even expansion of the program may be warranted. If new information is more likely to emerge from statutory changes, then that direction should be considered. Of course, if a statutory approach is unappealing for its unilateral nature, then a treaty approach would allow the United States to derive an additional benefit from a change in position. The slow pace of the treaty process also would provide more opportunity for the United States to modify its view of branch taxation, although it would not offer as much flexibility for the government as the APA process.

The risk of abuse certainly weighs heavily in the government's analysis of the alternatives. However, specificity about the abuses envisioned can help direct the choice of approach. If the risk of abuse derives from too many taxpayers using interbranch contracts (at least initially), then a general recognition rule would be undesirable and a more restrictive approach might be preferred if it reduced the volume of taxpayers with recognized interbranch contracts.²⁵⁵ If instead, the risk of abuse derives from nonfinancial entities using interbranch contracts (because the Service lacks information about their use), then a method that both limited the access of nonfinancial entities to recog-

²⁵⁵ The approach could be restrictive by type of business (through, for example, the limited recognition rule), by country (through the treaty process), or by design (through the APA process).

nition of interbranch contracts while permitting the gathering of data about nonfinancial entities' use of the contracts would be appropriate.

In sifting through these factors and possible approaches it is clear that all of the factors are relevant. The question is how they should be weighted, which in turns depends on information about taxpayer behavior, much of which is directly or indirectly available through the APA process and thus is in the domain of the Service. The best rule is the one that most successfully integrates the impact of legal status, legal distinctions, and economic ownership, while being simultaneously sensitive to administrative concerns of the Service.

Based on information currently available, the limited recognition rule appears to be the most viable approach. It offers recourse for the taxpayers most likely to suffer from whipsaws and unpredictable taxation under the current rules governing risk-shifting within a single corporation. It also enables the United States to confront the problem in a way that harmonizes its treatment with that of many OECD countries. Moreover, the scope of a limited recognition rule incorporates the Service's concerns regarding abuse and administrability. If an APA program were simultaneously operated, it could serve as a complementary tool in the development of the tax law by continuing to gather information while serving as an outlet for taxpayers not covered by the statutory provision. In the future, the balance of taxpayer needs and administrative concerns might permit adoption of a more comprehensive approach.

CONCLUSION

The current U.S. approach to the taxation of risk-shifting within a single multinational corporation presents a serious obstacle to the growing international financial markets. Not only are the U.S. rules arbitrary and internally inconsistent, they are also in direct conflict with those of most other major industrialized nations. The United States developed these rules based on an incomplete understanding of contractual risk-shifting. In evaluating risk-shifting transactions, the United States has primarily focused on legal status. The government has relied on a party's status as a legally independent entity to treat it as a separate taxpayer and thus recognize its transactions. Unfortunately, the legal status analysis fails to incorporate the two other factors, economic ownership and legal distinctions, that are critical to designing a tax treatment consistent with the underlying economic transactions.

There are, however, several alternative methods for taxing risk-shifting within a corporation, all of which more successfully integrate the impact of legal status, legal distinctions, and economic ownership. As a result, a move to one of these regimes would offer more sensible taxation of cross-border risk-shifting without compromising the United States' administrative goals. Moreover, the choice among the alternatives could be based on the government's assessment of each plan's respective implementation trajectory. Ultimately, the issues raised by the risk-shifting transactions not only reveal the complex interaction of economic ownership and taxable units, but also highlight the need for critical examination of these core concepts in the tax system.