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UNITED STATES TAX AND SECURITIES LAWS: WORKING "TOGETHER" TOWARD DIFFERENT GOALS IN EUROBOND FINANCINGS

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I. INTRODUCTION

A. *The Growth and Development of the Eurobond Market*

The recent growth of international financial markets was preceded

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by the development and proliferation of the Eurobond market.[1] Scholars generally agree that the Eurobond market came into existence in 1963 as a result of the multinational issuance of United States dollar-denominated debt by Autostrade of Italy.[2] The importance of the Eurobond market, which is part of the larger "international financial market,"[3] is emphasized by its enormous size and trading volume.[4]

Several factors have led to the growth of the Eurobond market. One of the single most important events which contributed to its development was the imposition of the Interest Equalization Tax ("IET") in 1964.[5] The IET made it more expensive for foreign issuers to borrow United States dollars within the United States. The IET was a levy on United States holders of foreign securities[6] which was designed to eliminate any comparative advantage foreign issuers may have had over domestic issuers in the United States domestic market.[7] Foreign issuers' need for United States dollars then had to be satisfied from sources outside the United States. A huge pool of dollar-denominated deposits in non-United States banks fulfilled this need. These deposits became known as Eurodollars.[8]

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1. The prefix "Euro-" has become a misnomer in that, while the original Eurobond market was centered in London and spread throughout Europe, today the Euromarket has expanded throughout the world and has no national or regional boundaries.

2. *See, e.g.*, F. FISHER, INTERNATIONAL BONDS (1981) (hereinafter FISHER); KERR, HISTORY OF THE EUROBOND MARKET (1984).

3. The international bond market, also a part of the international financial market, is made up of the Eurobond market and the "foreign bond market." The Eurobond market encompasses securities sold multinationally by international syndicates of underwriters. The bonds may be denominated in any convenient currency. The foreign bond market is comprised of bonds of foreign issuers that are sold into the domestic markets of another country. These are usually characterized by the use of a domestic syndicate and are denominated in the currency of the country where they are sold. The international equity market may be bifurcated similarly; however, discussion of this market is beyond the scope of this article. *See* E. Green, "Developments in International Finance: International Equity Offerings Abroad," (Nov. 8, 1986) (paper presented at Practicing Law Institute, 18th Annual Institute on Securities Regulation).

4. *See generally* F. FISHER, *supra* note 2.

5. Pub. L. No. 88-563, 78 Stat. 809 (1964). Section 2(c) of the IET made the tax retroactive to July 18, 1963.

6. The IET also applied to offerings by United States issuers who sold their securities abroad but made a withholding tax election under Sec. 4912(c) of the Internal Revenue Code [hereinafter I.R.C. or Code]. However, this procedure was not available until 1971. *See* Brooks, *The Emerging Asiadollar Market*, U.C. SAN DIEGO, 13TH ANN. SEC. REG. INST., 12-16 (1986).

7. The IET lapsed in January, 1974.

8. Eurodollars are deposit liabilities, denominated in United States dollars, of

The enormous growth of the Eurobond market can also be attributed to a comparative absence of comprehensive regulation. This comparative lack of oversight allows issuers to tailor their securities to include features making them attractive to a wide range of investors and to bring them to market very quickly. Most importantly, the bearer form instruments commonly issued in the market provide anonymity and freedom from withholding taxes on payments of interest.[9] Lower borrowing costs[10] for issuers can also lead to higher rates of return on Eurobonds than those found in other types of issues. The constant shifting of international exchange and interest rates provides an additional incentive to invest, whether for speculative, hedging or diversification purposes.[11]

B. *The Effects of United States Tax and Securities Laws on the Eurobond Market*

Although the IET has lapsed, the effects of United States tax laws on the operation of the Eurobond market have continued. United States tax laws continue to define in large part the types of instruments available to United States issuers and investors in the Eurobond market. Similarly, through the application of Release 4708,[12] United States securities laws have shaped the nature of the participation of United States companies in the market.

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banks located outside the United States. They are characterized by their large size (usually in excess of $500,000) and the fact that they are time deposits on which interest is paid. Eurodollar deposits should be distinguished from demand deposits in United States banks. *See* discussion in Goodfriend, *Eurodollars, reprinted in* T. COOK & B. SUMMERS, INSTRUMENTS OF THE MONEY MARKET 123 (5th ed. 1981); Eiteman, *International Capital Markets*, in INTERNATIONAL BANKING: PRINCIPLES AND PRACTICES, 56, 60-66 (E. Roussakis ed. 1983). For a discussion of the mechanics involved in the creation of Eurodollars, *see* D. EITEMAN & A. STONEHILL, MULTINATIONAL BUSINESS FINANCE, 387-95 (4th ed. 1986).

9. This greatly contributed to the early growth and development of the market. Since the market has matured, it has been characterized by the presence of more institutional investors. These investors tend not to demand the features of anonymity and freedom from withholding tax.

10. For example, a United States issuer can avoid filing fees and some professional expenses by not registering its securities with the Securities and Exchange Commission (the "Commission").

11. *See* F. FABOZZI & I. POLLACK, THE HANDBOOK OF FIXED INCOME SECURITIES 637-43 (1983).

12. Statement of the Commission relating to registration of foreign offerings by domestic issuers and registration of underwriters of foreign offerings as broker-dealers, Securities Act Release No. 33-4708 [1 Securities Act] Fed. Sec. L. Rep. (CCH) ¶1361, at 2123 (July 9, 1964) [hereinafter Release 4708].

Despite the fact that the Eurobond market exists outside the confines of any particular country, United States securities and tax laws have a significant influence on the market.[13] Among other things, this influence is due to the size and depth of the United States capital market. Its broad investor base provides a large demand for all types of securities, including those that may have been originally issued outside the United States and not registered under the Securities Act of 1933 ("1933 Act"). Large, well-established foreign issuers know that a market may develop in the United States for new issues of their securities, especially if there already exists a market for their other securities. Additionally, many foreign underwriters have a presence in the United States, either directly or through an affiliate, and do not want to risk overstepping regulations of the Securities and Exchange Commission ("Commission"). Restrictions or regulations imposed by securities or tax regulatory authorities in the United States have an impact on the Eurobond market because of, *inter alia*, the extent of the involvement both of United States entities abroad and foreign entities in the United States.

One effect of United States regulations on the Euromarket can be observed in the context of certain United States tax regulations that adopt and rely on United States securities regulations. One of the common threads connecting United States tax and securities laws is their goal of ensuring foreign placement of the initial distribution of securities sold by United States entities abroad.[14] Activities that are prohib-

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13. After the imposition of the IET in 1964, several other United States regulatory activities had an impact on the development of the Eurobond market. In 1965, voluntary restraints were imposed on capital formation by United States multinational corporations. These were designed to promote financing of foreign operations through capital formation abroad. The change in 1968 of the nature of the program from voluntary to mandatory, coupled with the creation of the Office of Foreign Direct Investment to administer the controls, greatly increased the amount of Eurodollar bonds issued by United States corporations. The years the Mandatory Restraint Program was in effect (1968-1973) saw United States corporations float 271 Eurobond issues for a total of $6,978 million, or nearly 33 percent of the entire market over the period. F. FISHER, *supra* note 2, at 21.

14. It may be noted that neither the United States tax laws nor the registration provisions of the 1933 Act purport to inure to the benefit of foreign persons or foreign capital markets. Tax regulations, which are published by the Department of the Treasury ("Treasury"), are designed primarily to minimize tax avoidance that may be accomplished through the purchase of bearer bonds by United States persons. The regulations, however, do not seek to prevent the sale of bearer bonds to foreign persons nor do they otherwise address taxpayer compliance problems abroad. The 1933 Act registration provisions seek to protect United States investors by ensuring that no unregistered securities are distributed to United States persons in connection with their origi-

ited in the United States are expressly facilitated, if conducted abroad, by tax regulations regarding bearer form obligations and registration provisions under the 1933 Act. Protection of United States fiscal policy and investors is clearly the foremost consideration behind these regulatory schemes.

The common efforts of tax and securities regulators to ensure foreign placement of bearer or unregistered securities may explain the adoption of tax regulations that are dependent on the securities regulations. Securities may be offered abroad without registration under the 1933 Act if the offeror complies with the provisions of Release 4708. Such offerings frequently involve requesting a no-action position from the staff of the Commission. The tax laws do not set forth independent procedures, however, for issuance abroad of bonds in bearer form by United States entities. Instead, the applicable United States Treasury Department ("Treasury") regulations incorporate by reference the securities procedures that are designed to ensure that such issues come to rest abroad.

C. *Using the Same Approach to Achieve Different Results: Potential Problems*

Although tax and securities laws are interrelated in their approach to foreign placement of securities, they each reflect different policy concerns. Questions therefore arise as to what policy considerations will result from changes in the securities regulations, which are incorporated in their present form into certain of the tax regulations. The question is not purely academic since reforms are likely to be made in applicable securities procedures due to calls from the securities industry for the Commission to address problems arising from the rapid evolution of the international capital markets.

Any potential changes of the relevant securities regulations will certainly have some effects on tax laws that refer to such regulations. However, the nature and degree of those effects will depend largely on the extent to which the Commission and the Treasury coordinate their efforts to ameliorate these effects. This paper identifies current securities law procedures for the sale of Eurobonds by United States entities, and discusses the extent of the reliance on those procedures by Treasury regulations. Problems that may result from a unilateral change in the securities procedures are then identified, and their potential impact

nal issuance. The viewpoint of the Commission in this regard is evidenced by its policy of allowing, under Release 4708, the sale of unregistered securities to foreign persons despite the use of the jurisdictional means of the 1933 Act.

on existing tax regulations is addressed.

II. United States Securities Laws: Avoiding Sales of Unregistered Securities to United States Persons

A. *History and Purpose of Release 4708*

The Commission adopted Release 4708 in 1964 pursuant to certain recommendations of a presidential task force.[15] The task force concluded that action should be taken by the Commission to promote the sale of United States corporate securities and investment company shares to foreign investors. Specifically, the task force recommended the publication of a release setting forth the Commission's position regarding the applicability of the registration provisions of the 1933 Act to securities offered by domestic issuers to foreign purchasers.[16]

The registration requirements of the 1933 Act are broad and appear to extend jurisdiction to nearly any offering of securities by a United States issuer for which there is no available exemption. As long as interstate commerce is used, the 1933 Act contemplates an exercise of the Commission's jurisdiction.[17] However, despite jurisdiction, the Commission will generally decline to take any action to prevent the offering of securities by United States issuers to foreign persons if the securities will come to rest abroad. It is the Commission's position, as expressed in Release 4708, that the registration laws were primarily designed to protect United States investors.[18]

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15. *See* Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for United States Corporations Operating Abroad, Report to the President of the United States (April 27, 1964). In addition to several other areas of inquiry, all of which focused on reducing the United States' balance of payments deficit, the task force was charged with developing programs that would facilitate the marketing of United States securities abroad.

16. *Id.* at 7 (Recommendation No. 4). *See also* Release 4708, *supra* note 12, which recites this recommendation.

17. Section 2(7) of the 1933 Act, 15 U.S.C. § 77(b)(7) (1982), defines "interstate commerce" broadly so that any use of the mail or wires probably would be included. Further, the section specifically mentions that the jurisdictional means may take place between "any foreign country and any State, Territory, or the District of Columbia, or within the District of Columbia."

18. The release notes that if active trading develops in the United States shortly after the distribution abroad, it may "raise a question" whether the distribution had actually been completed abroad or whether the securities were being distributed in the United States or to United States persons.

B. *Designing a Foreign Issue That Will "Come to Rest Abroad"*

The Commission has, for many years, relied on Release 4708 in granting no-action letters to issuers of securities abroad. Eurobond issues by United States corporations during the period from 1964 to 1974 were accomplished without much difficulty because of the IET. The IET significantly reduced the likelihood that United States corporate securities issued abroad would flow back into the United States because an additional tax would have to be paid by United States holders. The Commission considered this fact to be a significant deterrent in several early no-action letter requests.[19]

After the IET's financial disincentive disappeared with its expiration in 1974, new procedures had to be developed to ensure that Eurobond issues would come to rest abroad.[20] Today, statements of the restrictions on sales to United States persons are required in invitation telexes, in the prospectus or offering circular, and in any press release or advertisement regarding the issue.[21] Also, contractual clauses which state that the securities will not be sold to United States investors re-

19. *See, e.g.*, Pioneer Systems, Inc., SEC No-Action Letter (Dec. 30, 1971); Optical Systems Corp., SEC No-Action Letter (Apr. 2, 1973); IU International Corp., SEC No-Action Letter (Aug. 24, 1973); American Motors Corp., SEC No-Action Letter (Jan. 16, 1974); Sperry Rand Corp., SEC No-Action Letter (Mar. 1, 1974).

20. Although Release 4708 refers specifically only to domestic issuers, its provisions and the procedures established by the staff through its no-action letters have been adhered to often by foreign issuers of Eurobonds and other international offerings. Despite the fact that an issue may be floated by a foreign entity and distributed completely without the United States, there is a significant possibility for flow of the securities into the United States, especially in the case of well-known issuers or those for which a market exists in the United States for their securities. Many of these foreign issuers or their underwriters (which may be foreign or United States entities or affiliates) deal frequently within the United States, so in order to avoid any potential for running afoul of the Commission's rules, Release 4708 procedures are complied with.

21. The first company to utilize procedures similar to those discussed in this paragraph was Pacific Lighting Corp. In Pacific Lighting Corp., SEC No-Action Letter (May 14, 1974), in addition to contractual restrictions, the staff noted in granting the request for a no-action letter that while the "economic restraints" that existed during the years of the IET had disappeared, certain "practical restraints" in the form of marketing considerations now provided a disincentive to investment in United States corporate Eurobond issues. These included the bearer form of the instruments which differed from the registered form that United States investors were accustomed to; annual instead of semi-annual interest payments; a limited secondary market for the issues; and a distribution plan that would target wholesale institutional investors rather than the traditional retail market in the United States. The contractual procedures were further formalized in Singer and Co., SEC No-Action Letter (Aug. 2, 1974), and references to marketing distinctions declined in importance for purposes of analysis under Release 4708.

siding abroad for 90 days following the completion of the distribution[22] must be included in the underwriting and selling group agreements. Additionally, the confirmations of sale sent to the managers of the underwriting syndicate must include representations that the final purchasers are not United States persons. Finally, only temporary certificates or a single global certificate are delivered at closing. These certificates may be exchanged for definitive securities 90 days after the completion of the distribution.[23] This is referred to as the "lockup" period.[24]

C. *Who is a United States Person?*

The term "United States person" is nowhere defined in the 1933 Act. Nevertheless, the concept is important because sales to United States persons are prohibited in distributions which are not registered under the 1933 Act, but rather sold in reliance on Release 4708. As currently applied by the staff, the definition includes persons within the United States as well as United States citizens who reside abroad.

In addition, the term "United States person" is significant because Treasury regulations applicable to the sale of bearer form Eurobonds by United States corporations incorporate the term by reference.[25]

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22. It should be noted that for equity securities, the required period now appears to be 12 months. *See* InfraRed Associates, Inc., SEC No-Action Letter, (Sept. 13, 1985). Legends are also required on shares describing the restriction on the transfer thereof.

23. *See, e.g.*, Proctor & Gamble Co., SEC No-Action Letter (Feb. 21, 1985). For a discussion of the development of Commission no-action positions relying on Release 4708, *see* Evans, *Offering of Securities Solely to Foreign Investors*, 40 BUS. LAW. 69, 70-76 (1984); Mosteshar, *The Internationalization of the Securities Markets - Europe*, in U. C. SAN DIEGO, 13TH ANN. SEC. REG. INST. 47-53 (1986); Beller, *Current Legal Issues in Euromarket Financing*, INTERNATIONAL FINANCIAL OFFERINGS 11, 18-27 (1985); Nathan, *Special Problems Arising As a Result of Trading in Multiple Markets*, 4 J. COMP. CORP. L. & SEC. REG. 225, 226-30, 237-40 (1982).

24. The lockup period has become easier to manage in the past few years with the advent of the global temporary certificate. Prior to use of the global certificate, individual temporary certificates were issued to purchasers who then had to trade them in after the lockup period for permanent securities. The permanent securities would not be issued without certification by the holder of the temporary certificate that the beneficial owner was not a United States person. With the global certificate, the same certification is required, but all securities are represented in their temporary form by a single global certificate. The permanent securities are issued after the lockup period in traditional form in many cases.

25. *See* Treas. Reg. § 1.163-5T(c)(2)(i)(A), T.D. 8046, 50 Fed. Reg. 33, 524 (1985). I.R.C. § 163(f)(2)(B)(i) excludes from the definition of "registration-required obligations" those that are sold under arrangements reasonably designed to ensure that

Since the Treasury regulation incorporates a concept that has no precise definition, and is subject to interpretation by the staff of the Commission, the regulation could, in the event such interpretation is changed, cause United States corporations to be uncertain of their compliance with Treasury regulations.

III. UNITED STATES TAX LAWS: AVOIDING SALES OF BEARER BONDS TO UNITED STATES PERSONS

As previously noted, the success of Eurobond issues depends largely upon the anonymity provided by the bearer form of the securities and the freedom from withholding taxes that they provide. Since these characteristics are essential marketing considerations, it is necessary for United States issuers to mold their procedures to conform with the ever-changing tax laws that affect these characteristics. The tax laws discussed below have had a significant impact on both of these aspects of Eurobond issues by United States companies. The following discussion is limited to the provisions that are both central to the regulatory pattern and that rely on interpretations of the securities laws.

A. *The Tax Equity and Fiscal Reform Act of 1982 and Registration-Required Obligations*

No statutory restrictions on the issuance of Eurobonds in bearer form by United States companies existed prior to the passage of the Tax Equity and Fiscal Reform Act of 1982 ("TEFRA").[26] However, withholding tax considerations prevented direct issuance from being a viable alternative in most cases.[27] It became common to use a Netherlands Antilles subsidiary to avoid the withholding tax on payments of

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the obligations are sold only to persons who are not United States persons. The Treasury regulation states that the sale of an obligation meets this test if, among others, it meets the tests under the 1933 Act for distribution to non-United States persons. This not-so-veiled reference to Release 4708 goes on to say that for purposes of the subparagraph of the regulation, "the term 'United States person' has the same meaning as it has for purposes of determining whether an obligation is intended for distribution to persons that are not United States persons under the Securities Act of 1933."

26. Pub. L. No. 97-248, 96 Stat. 324 (1982).

27. Payments to foreign persons of interest not "effectively connected" with the conduct of a trade or business within the United States ("effectively connected income") are subject to withholding tax at source. Section 871(a)(1) of the Code imposes a 30 percent tax on interest and original issue discount income received from such sources by nonresident alien individuals, while "effectively connected" income is taxed under I.R.C. § 861(a)(1). Although several statutory exemptions exist by which this tax can be avoided, these simply were not available to most corporations.

interest to foreign persons.[28]

The use of the Netherlands Antilles as a location for the establishment of a captive foreign finance subsidiary was popular because it was the beneficiary of a tax treaty with the United States. The treaty exempted payments to foreign subsidiaries of interest on loans made to their United States parent or affiliate from withholding tax. The treaty did not impose any withholding, estate or inheritance tax on payments of interest to nonresident persons (*i.e.*, the holders of the Eurobonds), and no exchange controls prevented financing in this manner.[29]

Enacted partly in response to Congressional concern over avoidance of taxes by United States persons, TEFRA included provisions requiring certain debt obligations, designated as "registration-required obligations," to be issued only in registered form.[30] Registration-required obligations are those offered to the public by non-natural persons and having a maturity of more than one year.[31] However, in response to the concerns of the securities industry,[32] the so-called

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28. In addition to the statutory exemptions from the withholding tax, certain tax treaties could be used for the same purpose. The most familiar and frequently used of these was the treaty with the Netherlands, as extended to the Netherlands Antilles. *See generally* Pront & Zaitzeff, *Repeal of the United States Withholding Tax on Interest Paid to Foreigners*, 3 INT'L TAX & BUS. LAW. 191, 195-201 (1986) [hereinafter Pront]; Newburg, *Financing in the Euromarket by U.S. Companies: A Survey of the Legal and Regulatory Framework*, 33 BUS. LAW. 2171, 2190-94 (1978) [hereinafter Newburg]; Wales, *Repeal of 30 Percent Withholding: A Case Study in Complexity*, 12 J. CORP. TAX. 352, 353-55 (1986) [hereinafter Wales].

29. Several steps were involved in the offering process. After the subsidiary was formed and capitalized with usually one-third to one-fifth of the amount of the contemplated Eurobond offering, the subsidiary would then issue Eurobonds guaranteed by the parent. The proceeds would then be lent to the United States parent, which would repay on terms designed to facilitate the subsidiary's ability to make the payments when due on the Eurobonds. Under provisions of the treaty, the payment of interest on these inter-company loans would be free of withholding tax, as would payments of interest on the debt issued by the Antilles subsidiaries. For a fuller discussion of this process, *see* Newburg, *supra* note 28, at 2190-94; Beller & Berney, *Eurobonds*, 19 REV. SEC. & COMMODITIES REG. 39 nn. 1 & 2 (1986).

30. I.R.C. § 163(f) (1987) (as amended by TEFRA § 310(b)(2) (1982)).

31. I.R.C. § 163(f)(2)(A)(1987). Interest payments on registration-required obligations that are not issued in registered form subject the issuer to denial of the standard interest deduction from its income. I.R.C. § 163(f)(1) (1987). Further, there is an imposition of an excise tax of one percent of the total principal amount of the obligation multiplied by the number of years in its original maturity. I.R.C. § 4701(a) (1987). Finally, the holder of a registration-required obligation that is issued in bearer form is subject to penalties in the form of disallowance of capital gains treatment or deduction of any loss upon the sale or exchange of the instrument. I.R.C. § 165(j) (1987).

32. *See* discussion in Newburg, *United States Companies and International*

"Eurobond exception" was carved out of the definition of registration-required obligation.[33]

The Eurobond exception in TEFRA allows issuance of bearer obligations under "arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person,"[34] as long as interest is payable only outside the United States,[35] and if there is a statement on the face of the obligation that any United States holder of the obligation is subject to certain limitations under the United States tax laws.[36] This exception, coupled with the repeal by the Tax Reform Act of 1984 ("TRA")[37] of the United States withholding tax on payments of portfolio interest to foreign persons, allowed United States corporations, for the first time, to access directly the Eurobond market.[38]

This was a new procedure for most United States corporate issuers, and initially there was confusion about what methods would comply with the exception. The Code provides that no deduction will be allowed by a corporation for any interest payment on a registration-required obligation that is issued in bearer form.[39] However, the Eurobond exception applies to obligations that are sold under arrangements reasonably designed to ensure that such obligations will be sold (or resold in connection with the original issue) only to foreign persons.[40] In addition to meeting the requirements as to the "arrangements reasonably designed" condition, other requirements apply.[41]

Financings, 20 INT'L LAW. 765, 766 (1986).

33. I.R.C. § 163(f)(2)(B) (1987).

34. I.R.C. § 163(f)(2)(B)(i) (1987). The tax law thus incorporates applicable securities law by this indirect reference to Release 4708. *See* Kau, *Recent Tax Law Developments on Eurobond Financings*, in INTERNATIONAL FINANCIAL OFFERINGS, 151, 157-58 (A. Beller ed. 1985).

35. I.R.C. § 163(f)(2)(B)(ii)(I).

36. I.R.C. § 163(f)(2)(B)(ii)(II). Under Treasury regulations, the legend must also appear on detachable coupons so that holders of stripped coupons will be placed on adequate notice of these provisions. Treas. Reg. § 1.163-5T(c)(1)(ii)(B).

37. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).

38. Shaping the issue so that the requirements for qualifying as "portfolio interest" are met is important regarding the ability to pay interest without withholding tax. *See* discussion *infra* at Part III(C).

39. I.R.C. § 163 (f)(1).

40. I.R.C. § 163(f)(2)(B)(i).

41. For example, interest on the obligations must be payable only outside the United States, and the face of the obligation must contain a legend warning of the consequences if it is held by a United States person. I.R.C. § 163(f)(2)(B)(ii); Treas. Reg. § 1.163-5T(c)(2)(i). The provisions regarding the required legend have been modified by the regulations also to require the legend to be placed on each detachable

Temporary Treasury regulations issued in August, 1984 addressed the problem by attempting to clarify what is meant in the statute by the "arrangements reasonably designed" clause.[42] According to the regulations, there are two general ways to satisfy this requirement.[43] The first method contemplates an issue of bonds which need not be registered under the 1933 Act "because it is intended for distribution to persons who are not United States persons."[44] An obligation will be considered as not being required to be registered under the 1933 Act if the issuer, in reliance on an opinion of counsel obtained prior to its issuance, determines in good faith that due to its intended foreign distribution, no 1933 Act registration is required. The regulation expressly incorporates the meaning of "United States person" as used under the 1933 Act for determining whether an obligation is intended for distribution to non-United States persons.[45]

The second way to comply with the "arrangements reasonably designed" clause is available for securities that are either registered under the 1933 Act, or do not qualify as securities within the meaning of that Act. Such obligations may qualify for the exception from designation as a registration-required obligation if the five conditions described below are met.[46] The conditions for these types of obligations are much less flexible than for those previously mentioned because this type of obligation is more easily obtained in the United States than those which are specifically designed to be marketed abroad.

The obligation must be issued for sale or resale and delivery only outside the United States and its possessions.[47] Second, the issuer must not, and each underwriter and selling group member must covenant that it will not, offer to sell the securities to United States persons in connection with the original issuance.[48]

The third condition requires that a confirmation be sent to each ultimate purchaser of the bonds which states that the purchaser is not a

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coupon. Treas. Reg. § 1.163-5T(c)(1)(ii)(B).

42. Treas. Reg. § 1.163-5T(c)(1)(i).

43. Treas. Reg. § 1.163-5T(c)(2)(i). The regulation also sets forth conditions dealing specially with foreign issuers and foreign branches of United States banks. Treas. Reg. § 1.163-5T(c)(2)(i)(C).

44. Treas. Reg. § 1.163-5T(c)(2)(i)(A).

45. *Id.* This is true despite the fact that the term is not defined either in the 1933 Act or in rules adopted by the Commission.

46. Treas. Reg. § 1.163-5T(c)(2)(i)(B).

47. Treas. Reg. § 1.163-5T(c)(2)(i)(B)(1).

48. Treas. Reg. § 1.163-5T(c)(2)(i)(B)(2). There is an exception, however, for certain United States financial institutions.

United States person.[49] Definitive certificates representing the obligations may not be issued until the person entitled to physical delivery has presented a certificate stating that the obligation is not being acquired on behalf of a United States person.[50] Finally, the issuer, underwriters and members of the selling group must not have actual knowledge that any purchaser of the securities is a United States person.[51] The temporary regulations also provided that an obligation which was convertible from registered form into bearer form would not qualify for the Eurobond exception.[52]

If Eurobonds are to be issued in bearer form, which they must in order to be marketable, they must be issued pursuant to the exception in order to avoid the imposition of withholding tax, information and reporting requirements, and sanctions on both the issuer and holders of the obligations. In addition to the disallowance of the interest deduction[53] and the inability of a corporation to reduce its earnings and profits by the amount of the interest paid,[54] failure to comply with the exception may subject an issuer to an excise tax in the amount of one percent of the principal amount of the obligation multiplied by the number of years in its original maturity.[55] Further, any holder of a registration-required obligation that is not in registered form will suffer certain disabilities regarding capital gains treatments on the obligations.[56] These considerations are paramount in any corporate financing decision involving the Euromarkets.

B. *IDTCA, Information Reporting and Backup Withholding*

Certain provisions of TEFRA impose information reporting requirements for purchasers of registration-required obligations in bearer

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49. Treas. Reg. § 1.163-5T(c)(2)(i)(B)(3).

50. Treas. Reg. § 1.163-5T(c)(2)(i)(B)(4). This certificate may, however, be provided by a clearing organization. In this case, the statement may be made in reliance on information supplied to the clearing organization by its members.

51. Treas. Reg. § 1.163-5T(c)(2)(i)(B)(5).

52. Treas. Reg. § 1.163-5T(c)(1). This early position caused some criticism, since it prevented the development of an efficient secondary trading market between the United States and the Euromarket. Such a liquid secondary market is desirable to facilitate access by United States issuers to the Eurobond market at the lowest possible cost. Two-way convertibility had been previously condoned by the IRS. *See* discussion in Pront, *supra* note 28, at 228-29. The convertibility prohibitions were deleted from the final regulations. T.D. 8110, 51 Fed. Reg. 45,453 (1986).

53. I.R.C. § 163(f).

54. I.R.C. § 312(m).

55. I.R.C. § 4701(a).

56. I.R.C. § 165(j).

form.[57] These requirements were strengthened with the enactment of the Interest and Dividend Tax Compliance Act of 1983 ("IDTCA"), which also added backup withholding provisions that would apply in case of failure to report the appropriate information.[58] Section 104 of IDTCA added I.R.C. Sec. 3406, which requires the imposition of a 20 percent backup withholding tax in the case of failures in the information reporting system.[59]

Although TEFRA imposed reporting requirements on the payors of interest on registration-required obligations,[60] it was possible under the regulations to achieve an offering that could be held anonymously by foreign persons under the tax provisions. This could be accomplished through several vehicles, including the use of a Netherlands Antilles subsidiary.[61] Under current regulations, if the payor has no actual knowledge that the payee is a United States person, the payment outside the United States of portfolio interest on an obligation is exempt from the information and backup withholding requirements.[62]

C. *The Tax Reform Act of 1984 and Repeal of the 30 Percent Withholding Tax*

By 1984, several aspects of the use of the Netherlands Antilles subsidiary as a vehicle for the issuance by United States corporations of Eurobonds had come under intense scrutiny by the Treasury Depart-

57. Section 309 amended I.R.C. § 6049 to require persons making interest payments on obligations such as bonds to report certain information, including the name and address of the person to whom it was paid. These requirements applied whether the Eurobond exception was available or not.

58. Pub. L. 98-67, 97 Stat. 369 (1983). *See* Technical Amendments added by IDTCA § 102 (e), 26 U.S.C. § 6049 (Supp. I 1983).

59. The backup withholding applies if the payee of the interest fails to report a correct TIN to the payor, if the payee underreports the interest income, or if the payor is notified of other defects in reporting by the Treasury Department. I.R.C. § 3406(a)(1).

60. I.R.C. § 6049(a). The provisions do not cover payments made to certain exempt recipients. These include, *inter alia*, payments on obligations issued by natural persons, payments to foreign persons that are otherwise subject to withholding tax, or payments deemed to be from sources outside the United States. I.R.C. §§ 6049(b)(2)(A), (C) and (D). However, Treasury regulations require in some cases certification by the foreign person under penalty of perjury as to its exempt status. Treas. Reg. § 1.6049-5(b)(2)(iv), T.D. 7881, 1983-1 C.B. 316.

61. Treas. Reg. § 1.6049-5(b)(4). Nevertheless, Treasury is given broad power by Congress to require registration of bonds that it determines are being used for tax avoidance by United States persons. I.R.C. § 163(f)(2)(C).

62. Treas. Reg. § 35a.9999-5, T.D. 8046, 1985-2 C.B. 61.

ment.[63] Problems of abuse were largely obviated, however, with the passage of the TRA. The need for a financing vehicle that provided interest payments to foreign Euromarket investors free from United States withholding taxes could now be met without going through the convoluted and artificial financing structure of the Antilles subsidiary. Section 127 of TRA repealed the tax and thus facilitated this desired result.[64]

A withholding tax of 30 percent is levied generally on United States source income attributable to nonresident alien individuals and foreign corporations.[65] Section 127 of TRA amended the withholding tax provisions so that they do not apply to interest received from certain portfolio debt investments.[66] In order to qualify for the exception from the general withholding tax, payments on the obligations must qualify as "portfolio interest." The Code defines "portfolio interest" to include that interest paid on two types of obligations: bearer obligations for which the Eurobond exception is available;[67] and registered form obligations including, *inter alia*, targeted registered obligations.[68] The statutory provisions thus encompass a broad range of securities.[69]

Immediately following the signing of TRA, there was some confusion in the industry about which types of instruments could be issued in bearer form directly by United States companies.[70] Some of this confu-

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63. Several audits had been and were being conducted of interest deductions taken by corporations in connection with their Antilles subsidiaries' issuance of debt. Several years earlier, the accepted required capitalization for these subsidiaries had been 5 to 1. *See* Rev. Rul. 70-645, 1970-2 C.B. 273. However, after the IET lapsed in 1974, this position was no longer followed by the IRS. In Rev. Rul. 74-464, 1974-2 C.B. 46, the IRS expressly revoked this position. *See* Pront, *supra* note 28, at 199-201.

64. For a discussion of the impact of the withholding tax repeal, *see* Federal Reserve Bank of Chicago, INTERNATIONAL LETTER, No. 562 (September/October 1986).

65. I.R.C. §§ 871(a); 881(a).

66. 98 Stat. 648.

67. I.R.C. §§ 871(h)(2)(A); 881(c)(2)(A). The Eurobond exception is found in I.R.C. § 163(f)(2)(B).

68. I.R.C. §§ 871(h)(2)(B); 881(c)(2)(B).

69. Several statutory exceptions to the definition of portfolio interest can also be found in the Code. These include payments of interest to ten percent shareholders or partners (I.R.C. §§ 871(h)(3)(B); 881(c)(3)(B)); interest payments on bank loans from foreign banks (I.R.C. § 881(c)(3)(A)); and interest payments to controlled foreign corporations from a related person (I.R.C. § 881(c)(3)(C)). Additionally to the enumerated exceptions, the Code gives Treasury the authority to designate circumstances where interest payments that would otherwise qualify will not constitute portfolio interest, such as a case of extreme tax evasion through the facilities of a foreign country. I.R.C. §§ 871(h)(5)(A); 881(c)(5).

70. *See, e.g., Special Registration for Foreign Investors*, 24 TAX NOTES 717 (Aug. 20, 1984).

sion was temporarily laid to rest with a press conference on August 16, 1984, by Treasury Secretary Regan and the subsequent issuance of temporary regulations.[71]

The temporary regulations outlined a three part test for determining whether an issuer complied with the Eurobond exemption from the TEFRA registration requirements.[72] In addition, the temporary regulations required that interest on such obligations be payable only outside the United States, and restricted conversion of registered instruments to bearer form.[73] Finally, the temporary regulations modified the provisions regarding deductibility of losses on bearer obligations that are required to be in registered form.[74] These regulations were further modified in August, 1985,[75] and were issued in final form on December 19, 1986.[76]

Thus, with the repeal of the withholding tax on portfolio interest payments to foreign persons, and the resulting ability of United States corporations to issue bearer bonds, United States tax laws no longer prevent straightforward access to the Eurobond market by United States corporate issuers. However, a study of the complexity of the tax regulations and the difficulties involved in their implementation suggests that United States issuers are still not on the same footing as foreign issuers in the Eurobond market.[77]

D. *Targeted Registered Offerings*

While it is clear that the Treasury is concerned with preventing tax avoidance by United States persons through the tax regulations, it should also be noted that the Treasury controls the form and circum-

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71. Despite efforts of Treasury to provide guidance in this area, the regulations adopted so far have failed to answer all questions or to quiet many criticisms. For example, issues remain as to the status of privately issued securities and other obligations, interest payments on which are excluded from the definition of portfolio interest. *See* Pront, *supra* note 28, at 209-216.

72. Temp. Treas. Reg. § 1.163-5T(c)(2)(i).

73. T.D. 7965 removed former temporary regulations under TEFRA that allowed this convertibility. This provision was deleted from the final regulations. *See supra* note 52.

74. Temp. Treas. Reg. §§ 1.165-12T, 1.1287-1T, T.D. 7965, 1984-2 C.B. 38.

75. T.D. 8046, 1985-2 C.B. 61. These temporary regulations clarified certain questions regarding the issuance of pass-through certificates and certification procedures regarding the issuance of targeted registered obligations. Further clarifications were issued in late 1986. T.D. 8111, 51 Fed. Reg. 45,461 (1986).

76. The final regulations became effective on January 20, 1987. T.D. 8110, 51 Fed. Reg. 45,453 (1986).

77. *See, e.g.*, Wales, *supra* note 28.

stances under which United States debt is issued. In view of the volume of United States government securities that are sold to foreign persons each year, the Treasury's regulations that indicate the terms of issuance take on a special significance. While many factors enter into decisions made in this area, only those policies regarding the sale of United States government securities that are relevant to the promotion of taxpayer compliance by United States persons are discussed here.

The Treasury's taxpayer compliance concerns are evidenced by its refusal to allow the government to issue its debt in bearer form,[78] although the practice is permitted by the Code.[79] The Treasury prohibition extends to both government-owned agencies and government-sponsored enterprises, as well as to obligations issued by other entities that are secured more than 50 percent by government-related obligations.[80] Nevertheless, such issues may be conducted in such a manner as to accomplish their placement "anonymously" in foreign markets. The United States has conducted several such offerings. Their success was evidenced by the enthusiasm of foreign purchasers, but industry members criticized the offerings and argued that the certification procedures are more cumbersome than many foreign investors wish to confront.[81] Such an offering is known as a foreign "targeted" offering, or a targeted registered offering.

The foreign beneficial owner of a security sold in a targeted registered offering need not identify itself if the registered owner is a financial institution and other conditions are met. For example, interest must be paid to the financial institution outside the United States, the issuer must have no actual knowledge that a United States person is the beneficial owner of the obligation, and elaborate certification procedures must be performed. This type of procedure has been used by governmental entities, and also by corporations issuing mortgage-backed securities offered abroad in targeted registered form. If the issue is conducted properly and ownership certification is provided, payments of

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78. *See* T.D. 7965, 1984-2 C.B. 38.

79. Treas. Reg. § 1.163-5T(c)(1).

80. *Id.* The cited regulation literally says that obligations "guaranteed by" government-related securities may not qualify for the exception from the registered-form requirement. A Sept. 7, 1984 Treasury Department news release, together with a letter dated Sept. 7, 1984, from Secretary Regan to Senate Finance Committee Chairman Robert Dole, are the only sources of support for the "more than 50 percent" standard regarding what constitutes a guarantee. Nevertheless, these articulated, if informal, positions have been followed by industry in the relatively few private targeted registered offerings that have been accomplished.

81. *See, e.g., Foreign Portfolio Interest Withholding Repeal Regulations: A Delicate Balance*, 26 TAX NOTES 404-06 (Feb. 4, 1985).

interest on the obligations will be considered "portfolio interest," and will qualify for the exception from withholding tax requirements.[82]

Certification procedures in targeted registered offerings are complex and cumbersome.[83] They require a statement of the name and address of the person providing the certification and a statement that, on the date of each interest payment, the beneficial owner was not a United States person. If appropriate certification is not made to the paying agent, the agent is required to withhold tax on any interest payments.[84] Recent amendments to the temporary regulations attempted to clarify the certification procedures without initial success.[85] Recent amendments have allowed issuance of targeted registered obligations that are convertible into bearer obligations.[86] Prior to the amendments, payments of interest on such obligations did not qualify as portfolio interest.[87]

Typical issuers in private targeted registered offerings are United States savings and loan institutions that are burdened with government-backed home mortgages and securities. An issue may be sold entirely abroad, or may be divided into two or more tranches, one of which may be privately placed in the United States contemporaneously with the foreign public offering. Issues typically are registered on a commonly used Eurobond exchange such as Luxembourg or London, and are offered in large denominations. Subject to the certification requirements described above, there is no withholding tax on payments of portfolio interest on the bonds.

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82. I.R.C. §§ 871(h)(2)(B), 881(c)(2)(B).

83. The procedures were originally established by Temp. Treas. Reg. § 35a.9999-5(b). The temporary regulations were amended December 19, 1986, with the amendments being made effective retroactively to July 18, 1984 (with the exception of one provision not relevant here). Temp. Treas. Reg. § 35a.9999-5(b), T.D. 8111, 51 Fed. Reg. 45,461 (1986).

84. *Id.* at Q&A 12. For a more detailed discussion of the certification requirements and marketing procedures involved in the issuance of targeted registered obligations, *see* Pront, *supra* note 28, at 231-32, 236-41.

85. Temp. Treas. Reg. § 35a.9999-5(b), at Q&A 19-20. Industry comments have been overwhelmingly negative to the revisions, which are complex and inject uncertainty into the operation of foreign targeted registered offerings. *See, e.g., Davis Polk & Wardwell Offers Amendment to Definition of 'Publicly Issued' Obligation*, 34 TAX NOTES 451 (1987); *NYSBA Tax Section Briefed on International and Corporate Tax Changes*, 34 TAX NOTES 441 (1987); *Rogers & Wells Finds Definition of 'Publicly Issued' Too Restrictive, Calls for Use of Single Corporate Statement*, 34 TAX NOTES 556 (1987).

86. *See* T.D. 8110, 51 Fed. Reg. 45,453 (1986); T.D. 8111, 51 Fed. Reg. 45,461, 45,464 (1986).

87. *See* Temp. Treas. Reg. § 1.163-5T(c)(1).

Partly due to the strong mortgage-backed securities market in the United States, there have been few targeted registered offerings conducted to date by private issuers.[88] The complexity of the procedures required for such an issue may also be one of the reasons for the reluctance of United States issuers to access the Euromarket in this manner. Originally, the issue of mortgage-backed securities in targeted registered form was severely limited. Temporary Treasury regulations expressly excluded from eligibility for qualification as portfolio interest several categories of obligations, including those issued by a natural person and privately placed securities. These problems were addressed by subsequent regulations, however, so that securities backed by government-supported agency certificates may be issued in bearer form through a targeted registered offering.[89]

IV. Conclusions

The United States tax and securities regulations regarding the issuance by United States entities of Eurobonds are very much interrelated. The tax laws incorporate by reference certain established procedures required by the securities laws — specifically those that have evolved under Release 4708. Tax rules that allow the issuance of bearer bonds by United States entities do so on the basis that the obligations will be bought and held by foreign persons. In order to ensure this result, tax regulations adopt the Release 4708 procedures designed to make the obligations come to rest abroad.

Despite this relationship, it is clear that the tax and securities regulations seek to achieve different goals. The tax laws seek to ensure foreign placement of bearer form securities so that the danger of tax avoidance by United States persons through this vehicle of anonymity will be minimized. However, the securities laws seek to ensure foreign placement of securities that have not been registered with the Commission in order to avoid the dangers addressed by the 1933 Act. Securities laws protect investors through, *inter alia*, full and fair disclosure of information. Despite these very different purposes, the tax laws have incorporated by reference certain securities law procedures regarding placement of securities in foreign hands.

In assessing the wisdom of the Treasury's decision to regulate such

88. Another reason for the small number of private targeted registered offerings is that prior to August 1985, the temporary regulations apparently excluded mortgage pass-through certificates from inclusion in the Eurobond exception.

89. *See* Temp. Treas. Reg. § 35a.9999-5(d), T. D. 8046, 1985-2 C.B. 61; Temp. Treas. Reg. § 35a.9999-5(d), T.D. 8111, 51 Fed. Reg. 45,461, at Q&A 21, 22 (1986).

an important area of international finance through incorporating by reference the regulations administered by the Commission, several questions are presented. It should be noted that where securities laws are referred to in the tax regulations, they are mentioned in a generic form, with no provision for any subsequent modifications of the securities laws or the effects thereof on the tax rules.[90] First, it is not known what the impact on the tax rules would be if the securities procedures under Release 4708 are significantly revised. Aside from any technical analysis of individual provisions, the first consequence of any change would be considerable uncertainty and confusion in the market. Even if the securities procedures were understood and implemented by issuers, there could be no certainty about compliance with the tax regulations, unless they were revised simultaneously.

In order to avoid such confusion in the event of proposed changes in Release 4708, it would be logical for the Commission and Treasury to try to coordinate their regulatory reforms. If Treasury is informed of the existence of impending changes in securities rules or procedures, it would be able to publicize its position on how the changes would affect existing regulations in an effort to minimize industry confusion.

Coordination with Treasury may have another desired result. Dialogue between Treasury and the Commission would allow Treasury to give the Commission some input into the decision-making processes regarding tax compliance procedures applicable to Eurobonds. This input may contribute to the development of a comprehensive, streamlined and understandable procedure for United States issuers to access the Eurobond market while meeting the goals of both the securities and tax regulators. Such coordination would facilitate the participation of United States issuers in the Eurobond market, and would perpetuate an atmosphere of effective tax compliance for United States persons and protection for those investors who may depend on the disclosure provisions of the 1933 Act.

As noted in preceding sections, the tax regulations that incorporate the securities procedures under Release 4708 are relevant to the ability of corporations to issue bonds in bearer form under TEFRA. Since this ability is essential for marketing purposes in the Eurobond market, a modification of these procedures could severely disable United States issuers under current tax regulations since they would no longer have a "clear" path to follow in order to comply with the Treasury regulations. Further, it is possible that the Treasury would rewrite its regulations in such a way as to impede the access of United States corpora-

90. *See, e.g.*, Treas. Reg. § 1.163-5T(c)(2)(i)(A).

tions to the Eurobond market in the interest of ensuring taxpayer compliance. This result should be avoided, especially in view of the growing competitive structure of the international financial markets in which it is essential for United States companies to be able to compete for capital on an equal footing with their foreign counterparts.

Another area where a substantial change in securities regulations would have a significant impact on tax compliance considerations involves the information and backup withholding provisions of TEFRA and IDTCA. These provisions generally require personal identification and tax information regarding holders of registration-required obligations, and provide for a backup withholding tax in the event that the information is not given or is inaccurate. However, if the paying agent has no actual knowledge that the holder is a United States person and the interest payments otherwise qualify as portfolio interest, then such interest payments are exempt from the information reporting and backup withholding requirements.

In this situation as well, securities regulations come into the picture. Interest payments on obligations issued pursuant to the Eurobond exception, and thus pursuant to the Commission's interpretations under Release 4708, may qualify as portfolio interest. Thus, any unilateral change in the securities procedures would have an impact on the issuance of Eurobonds. It would become unclear whether the information and backup withholding provisions would be applicable.

The tax regulations currently contemplate a distinction between securities that are distributed according to Release 4708 procedures and obligations that are either registered under the 1933 Act, are exempt from such registration pursuant to section 3 or 4, or that do not constitute a "security" within the meaning of the 1933 Act.[91] The former group of securities are, by definition, those which are intended to be distributed to foreign investors. Such distribution would necessarily involve a lockup period, during which no definitive certificates would be issued, in order to ensure that the obligations are placed with non-United States persons.[92] For the two latter types of obligations, it is not necessarily contemplated that they will come to rest abroad during the initial distribution.

For obligations that are issued pursuant to Release 4708 procedures and the Eurobond exemption, there is no requirement that tax be withheld, and the information and backup withholding provisions do

91. Treas. Reg. § 1.163-5T(c)(2)(i)(A) and (B).

92. *See, e.g.*, Singer Co., SEC No-Action Letter (Aug. 2, 1974); Pacific Lighting Corp., SEC No-Action Letter (May 14, 1974); Fairchild Camera and Instrument International Finance, N.V., SEC No-Action Letter (Nov. 15, 1976).

not apply. For obligations that are issued other than pursuant to these procedures, the same exemptions are available. However, such obligations must be issued under much more complicated procedures in order to qualify for the Eurobond exemption. This fact illustrates Treasury's concern that obligations which may be easily obtainable in the United States and that may be issued in bearer form could end up in United States taxpayers' hands and facilitate tax avoidance.

It therefore appears that Treasury is willing to tolerate the issuance of bearer form obligations only when the obligations are issued under arrangements that will result in their final placement with foreign investors. If there exists a relatively greater possibility that a particular type of obligation will end up with a United States person, more elaborate certification procedures are required with respect to issuance of that obligation. In response to a change in the securities regulations, the Treasury may merely adopt the more stringent certification requirements[93] for all obligations, including those now distributed under Release 4708 procedures. Such an approach would severely limit access of United States corporate issuers to the Eurobond market.

This point highlights the necessity for the Commission and the Treasury to work together on any reforms. At a minimum, dialogue will help to avoid the dangers outlined above. Ideally, it may contribute to the development of comprehensive regulations that not only work "together" toward a common end, but toward a common goal: that of promoting the growth of international financial markets and the abilities of United States issuers to participate without unnecessary regulatory interference.

93. Treas. Reg. § 1.163-5T(c)(2)(i)(B).