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Where a Tax Disadvantage Looms Large: Interest Expense and the American Corporate Return to South Africa

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WHERE A TAX DISADVANTAGE LOOMS LARGE: INTEREST EXPENSE AND THE AMERICAN CORPORATE RETURN TO SOUTH AFRICA

Given the breadth of its changes, the Tax Reform Act of 1986 ("TRA 1986")[1] marks a historic juncture in United States corporate taxation[2] as it significantly altered the decisional calculus for investments in areas as diverse as U.S. real estate[3] and international business.[4] In terms of the latter, nowhere is the magnitude of its impact clearer than in the management of interest expense[5] within multinational corporations ("MNCs").[6] As a result of TRA 1986, interest expense of all U.S. companies within a U.S. MNC is now dispersed across all of the group's income sources, foreign and domestic, irrespective of where loan proceeds are expended. In placing portions of such interest against foreignsource income,[7] the new interest expense rules in effect 'dilute'[8] the role the foreign tax credit election has in

1 Tax Reform Act of 1986, Pub. L. No. 99514, 100 Stat. 2085 (22 October 1986).

2 *See* Alan Murray, *Historic Act: Unparalleled Tax Bill Will Affect Everyone And Restore Corporate Levies to '70s,* Wall St. J., A Special Issue on the Tax Act of 1986, August 18, 1986, at 1 (1986).

3 *See* Julia K. Brazelton, *Tax Reform of 1986: Evaluating Investments in Residential Real Estate*, 66 Taxes 158 (1988); *see generally* A. ARNOLD, REAL ESTATE INVESTMENTS AFTER THE TAX REFORM ACT OF 1986, (1987).

4 See Douglas R. Sease & Thomas Kamm, *Tax Bill May Force New Practices Abroad,* Wall St. J., A Special Issue on the Tax Act of 1986, August 18, 1986, at 30 (1986).

5 See note and accompanying text, *infra.*

6 As it will be used here, the term "multinational corporation" denotes a group of corporations which are "privately owned and managed in one country" as opposed to transnational corporations which are "owned and managed by nationals in different countries." JOHN D. DANIELS ET AL., INTERNATIONAL BUSINESS: ENVIRONMENTS AND OPERATIONS, 9 (3rd ed. 1982)(hereinafter "Daniels").

7 *See* Keith F. Sellers & Deborah W. Thomas, *The Interest Allocation Rules for Foreign and Domestic Income,* 1 J. Int'l Tax'n 152 (1990)(hereinafter "Sellers and Thomas").

8 H. Onno Ruding, *U.S. Tax Policy is Hurting U.S. Multinationals operating in the EC,* 5 J. Int'l Tax'n 4 (1994).

reducing the worldwide tax burden of U.S. MNCs.[9] And inasmuch as MNCs from other industrialized countries operate under less onerous deduction rules, the interest expense reforms arising from TRA 1986 render American MNCs less competitive in both domestic and international markets.[10]

This Comment examines this global tax disadvantage in the context of U.S. corporations returning to South Africa, a country which recently concluded its first nonracial democratic elections. No longer burdened by international economic sanctions,[11] contemporary South Africa provides a unique landscape in which to view the deleterious effects the new interest expense rules have on corporate investment decisions. Specifically, it is argued that the incongruity between the primary U.S. tax planning goals that have emerged since TRA 1986 and current South African investment regulations may actually inhibit the return of U.S. manufacturing MNCs to South Africa.[12]

Three parts organize this Comment. The first part outlines the overall climate for foreign investment in South Africa and reviews the basic elements that comprise the market strategies of manufacturing MNCs. Part II examines the Internal Revenue Code (I.R.C.)[13] provisions and Treasury Regulations (Treas. Reg.) pertaining to interest expense allocations within multinational corporate groups, notes the overall impact these rules have had on U.S. manufacturing MNCs and briefly looks at the interest expense provisions employed in the British, German and Japanese tax systems. Part III discuss how the scope of U.S. economic sanctions, corporate divestitures patterns, and current exchange control and tax regulations in South Africa

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[9] U.S. tax provisions pertaining to foreign tax credits are discussed in Part I, *infra.*

[10] *See* AMERICAN BAR ASSOCIATION SECTION ON TAXATION, COMMENTS ON THE IMPAIRMENT OF THE ABILITY OF U.S.BASED MULTINATIONAL COMPANIES TO COMPETE IN THE UNITED STATES RESULTING FROM THE INTERESTEXPENSE ALLOCATION PROVISIONS, 7 (1991).

[11] An overview of sanctions applied by the U.S. and others is provided in Part III, *infra.*

[12] For an argument that sees the new interest expense rules as part of several recent changes in U.S. tax law which render multinational corporations less competitive globally, *see* James Leonard, Note, *The AntiCompetitive Effect of the Internal Revenue Code of United Statesbased Multinational Corporations*, 20 Denv. J. Int'l L. & Pol'y 493, 497501 (1992)(hereinafter "Leonard").

[13] All sections cited herein refer to the Internal Revenue Code of 1986, as amended.

magnify this tax disadvantage. This Comment concludes that joint ventures structured as foreign partnerships provide the most tax efficient vehicle for U.S. manufacturing MNCs to use in reinvesting in the South African marketplace.

PART I. INDEPENDENT SOUTH AFRICA AND MULTINATIONAL CORPORATE STRATEGY

After decades of internal struggle for liberation and ten years of international economic sanctions, South Africa conducted its first national, nonracial democratic elections during the last week of April 1994.[14] Two weeks later, Nelson Mandela, the leader of the African National Congress ("ANC"), became the first President of a democratic Republic of South Africa, at once burying apartheid while ushering in a new era of hope and prosperity.[15] No longer the "international pariah" it had become during the sanctions era, South Africa is now poised for a substantial inflow of foreign investment.[16] In fact, over $20 billion in foreign direct investment may flow into South Africa over the next few years.[17] The following section outlines the broad forces which may propel South Africa into an era of rapid economic growth.

A. *Investment opportunities in South Africa, circa 1994*

South Africa is considered a uppermiddleincome developing country,[18] having reached that level of economic development through the invidious apartheid system[19] which preserved ex-

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[14] Bill Keller, *Mandela Picks Old Comrades To Fill His New Government,* N.Y. Times, May 7, 1994 at 1.

[15] Keller, *Mandela Is Named President, Closing the Era of Apartheid,* N.Y. Times, May 10, 1994, at A1.

[16] *Investing in South Africa: U.S. Companies Warily Eye South Africa,* Wall St. J., Oct. 7, 1993, at A2(hereinafter "Investing in South Africa").

[17] Richard Thomson, *A miracle waiting to happen,* The Independent, July 1, 1994, *available in* LEXIS, Nexis Library, MDEAFR File.

[18] WORLD BANK, THE WORLD DEVELOPMENT REPORT 1994, 165 (1994).

[19] Through the codification of an array of discriminatory labor, travel and housing practices, the principle of separate development called apartheid in Afrikans became an elaborate system of institutionalized racism, one that systematically disenfranchised nonwhites from exercising meaningful political and social control over their lives. For a legal history of this system, *see* Frank Berman, *South Africa: A Study of Apartheid Law and Its Enforcement,* 2 Touro J. Transnat'l

ceptional living standards for its white citizenry while impoverishing and politically disenfranchising the vast majority of black South Africans.[20] Under apartheid, the South African economy developed a dual structure, with its Gross Domestic Product of roughly $110 billion[21] drawing heavily upon world prices for several highvalued mineral exports, namely gold, diamonds, coal, and strategic minerals.[22] While a well-developed commercial infrastructure, an established financial services sector and expansive consumer markets evidence its industrial development,[23] illiteracy, inadequate housing, malnutrition and a monstrous high unemployment rate among South Africa's black citizenry of 29 million remain salient features of South Africa's century of institutionalized racism.[24] Hence several large parastatals[25] and mining conglomerates[26] dominate a modern industrial sector whereas a fragmented informal sector continues to generates about 40% of all economic activity inside South Africa.[27]

L. 1 (1991). *See generally* JOHN DUGARD, HUMAN RIGHTS AND THE SOUTH AFRICAN LEGAL ORDER (1978).

20 *See generally* FRANCIS WILSON & MAMPHELE RAMPLEL, UPROOTING POVERTY: THE SOUTH AFRICAN CHALLENGE, (1989).

21 Europa, *Africa South of the Sahara 1994: South Africa*, 806 (23rd ed., 1994)(hereinafter "Africa South of the Sahara").

22 Strategic minerals include uranium, platinum, chromite vanadium, titanium, and manganese. *See generally* E.W. ANDERSON & G. H. BLAKE, THE REPUBLIC OF SOUTH AFRICA AS A SUPPLIER OF STRATEGIC MINERALS, (1984).

23 Investing in South Africa, *supra* note 16, at A2.

24 Marshall Loeb, *Returning to South Africa*, Fortune, Oct. 4, 1993, at 18.

25 Among the largest parastatals, until their recent privatizations, were the Industrial Development Corporation (IDC), Electric Services Commission (ESCOM), and the Iron and Steel Corporation of South Africa (ISCOR). For a historical look at the establishment of these and other parastatals, *see generally* H.B. FALKENA, THE SOUTH AFRICAN STATE AND ITS ENTREPRENEURS, (1980).

26 *See generally* DUNCAN INNES, ANGLOAMERICAN AND THE RISE OF MODERN SOUTH AFRICA, (1984); *see also* GEOFFREY WHEATCROFT, THE RANDLORDS, THE MEN WHO MADE SOUTH AFRICA, (1985); and HEDLEY CHILVERS, THE STORY OF DEBEERS, (1939).

27 INTERNATIONAL MONETARY FUND, ECONOMIC POLICIES FOR A NEW SOUTH AFRICA, (Desmond Lachman & Kenneth Bercuson, eds., 1993)(hereinafter "Lachman & Bercuson").

For multinational corporations, a key question is whether South Africa's highly charged politics,[28] organized in part by Zulu nationalism in the Natal region,[29] will maintain a degree of political risk that will prevent MNCs from returning there.[30] Lingering concerns about the rights of foreign investors to repatriate profits[31] and the ANC government's proposed changes in wealth taxation[32] continue to dampen investor confidence. To some analysts, the country's overall economic growth potential is limited, as the economy is said to be plagued by 'weak domestic demand, inability of penetrate international markets, rising operational costs and loss of consumer and business confidence.'[33] Additionally, most U.S. manufacturing MNCs do not see South Africa as a 'major sourcing point' for global exports.[34] In fact, South Africa "ranks only 30th among U.S. world export markets."[35]

Nevertheless, U.S.South Africa trade has steadily increased since the partial repeal of U.S. sanctions in 1991, with the U.S. becoming South Africa's largest trading partner two

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28 The Inkatha Freedom Party, the Zulu nationalist party, at first refused to participate in the Transitional Executive Council ("TEC") and the general election, in part because the TEC failed to consider the establishment of a separate Zulu state in the Natal region. At the end of 1993, some observers feared Inthaka would, through nonparticipation in the election and demands for an independent state, send the entire reform process into a spiral of uncontrollable violence. *Canada supports first multiracial elections in South Africa by contribution to $2.5 million,* Canada Newswire Dec. 13, 1993, *available in* LEXIS, Nexis Library, Business File.

29 Patti Waldmeir, *Hopes of glory, fears of blood,* Fin. Times, Jan. 1, 1994, at 7.

30 Before and after the Transitional Executive Council assumed the reigns of government in December 1993, several violent clashes between rival political parties placed the April elections in jeopardy, causing a few foreign corporations to dissolve their investments For example, a German consortium, citing the country's uncertain future, sold its South African holdings in late 1993. *South Africa: Germans pull out of Martin Jonker,* Bus. Day, Dec. 1, 1993, at 8.

31 Mandela has maintained, since his release in February 1990, that the ANC's previous calls for nationalization of industries were outdated. *See Southern Africa Monitor,* Afr. Econ. Dig. May 28, 1990, at 3.

32 *ANC denies that wealth levy scheme is policy,* S. Afr. Rev., Nov. 1991, at 6.

33 Econ. Intelligence Unit, *Country report: South Africa* 29 (1st , 1994).

34 Bill Keller, *In Mandela's South Africa, Foreign Investors are Few,* N.Y. Times, Aug. 3, 1994, at A1.

35 Market Reports, *South Africa Overseas Business Report,* June 16, 1993, *available in* LEXIS, Nexis Library, BUSANL File.

years later.[36] In fact, American goods comprised 14% of South Africa's import needs in 1992.[37] With its population of 39 million expected to double by the year 2020 and with economic growth projected to be 5% annually during the next decade, a diverse range of industries, including food processing, avionics, household appliances, and pharmaceuticals, display solid growth potential for U.S. manufacturers.[38] Indeed both white and black consumer markets impart a distinct awareness of and desire for American products.[39]

Given the large aid pledges[40] that accompanied the unveiling of ANC's reconstruction and redevelopment program last December, voluminous amounts of foreign aid is expected to flow into South Africa over the next decade.[41] The U.S. has

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[36] Amy Kaslow, *Trade with S. Africa gathers steam,* Christian Sci. Monitor June 30, 1994, at 9 (hereinafter "Kaslow").

[37] Market Reports, *South Africa,* Sept. 15, 1993, *available in* LEXIS, Nexis Library, BUSANL File (hereinafter cited as "Market Reports, Sept. 15, 1993").

[38] Some economists believe that the South African economy has the potential to grow at an annual rate of more than five percent. Market Reports, *South Africa: Country Marketing Plan FY '94,* Dec. 20, 1993, *available in* LEXIS, COMPNY Library, BUSOPP File.

[39] *Id. See generally* RICHARD W. HULL, AMERICAN ENTERPRISESIN SOUTH AFRICA, 242295 (1990); *see also* VICTOR RAZIS, THE AMERICAN CONNECTION: THE INFLUENCE OF UNITED STATES BUSINESS ON SOUTH AFRICA, (1986); CHRISTOPHER COKER, COLLECTIVE BARGAINING AS AN INTERNATIONAL SANCTION: THE ROLE OF U.S. CORPORATIONS IN SOUTH AFRICA.

[40] After a ten year ban, the U. S. Senate in September 1993 repealed the Gramm Amendment which prevented South Africa from receiving any type of assistance from International Monetary Fund ("IMF") or the World Bank and restored recipient status to South Africa. Stella Dawson, *Mandela urges investment without foreign meddling,* Reuter Newswire, Sept. 25, 1993, *available in* WESTLAW, INTNEWS Database. The World Bank earmarked $1 billion for development projects in education and urban infrastructure in mid1993. Rory Channing, *South Africa may soon return to IMF fold,* Reuter Newswire, Sept. 17, 1993, *available in* WESTLAW, INTNEWS Database. Additionally, the International Monetary Fund provided the TEC a temporary financing facility totalling $849 million in order to bolster the country's balance of payments deficit. *IMF approves $849 million loan to South Africa, first in a decade,* BNA International Bus.& Fin. Daily, Dec. 27, 1993, *available in* LEXIS, Nexis Library, BNADNEWS File.

[41] At that time the ANC released a longterm assessment of the economy and outlined the policies it would pursue if elected. Economist Intelligence Unit, *Country Report: South Africa,* 20 (1st, 1994); *South Africa Set For Investmentled Growth* Reuter Newswire, Dec. 2, 1993, *available in* LEXIS, Nexis Library, INTNEWS File.

already committed $600 million to South Africa,[42] with most of this aid being tied to the procurement of U.S. products and services. Companies providing the types of goods and services that pertain to housing, health care and infrastructure the sectors targeted for massive public sector investment under the ANC's plan may secure large international contracts.[43]

Also in view of the country's position of economic hegemony in the subcontinent, South Africa's domestic markets impart a distinct regional dimension.[44] Realignment of the several regional economic organizations could provide South Africa with as much as $250 million in increased exports.[45] Since Western MNCs have long viewed South Africa as a natural launch pad into the markets of neighboring countries,[46] changes in the regional economy will certainly increase foreign direct investment in South Africa's manufacturing base.

Lastly, official encouragement and favorable regulatory action in both countries continues to facilitate U.S. manufacturer investments in South Africa. For instance, over $50 million in political risk insurance available from the United States Overseas Private Investment Corporation[47] is readily available.[48] A

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[42] Steve Holland, *Clinton to Raise U.S. Aid to S. Africa to $600 Million,* J. Com., May 6, 1994, at 3A.

[43] For example, due to the country's desperate need for inexpensive housing, manufacturers of prefabricated housing may secure modest to lucrative contacts contained in USfinanced development projects. *See* Paula Green, *South African Companies to Visit U.S. In Bid to Strengthen Trade Links,* J. Com., June 17, 1992, at 5A.

[44] *See generally* JOSEPH HANLON, BEGGAR YOUR NEIGHBOURS, (1986). Regional dependence on products manufactured in South Africa, may actually intensify if South Africa enters into a regional free trade zone with the members of the recently reorganized Southern African Development Community. For a concise view as to the role South Africa could have in such a scenario, *see* Erich Leistner, *Designing the framework for a Southern African Development Community,* 22 Afr. Insight 4 (1992).

[45] Gary S. Eisenberg, *The Policy and Law of Foreign Direct Investment in the New South Africa,* 28 J. World Trade 5, 25 (hereinafter "Eisenberg").

[46] *Gateway to a continent,* Asian Bus., Mar. 1992 , at 42. In announcing its joint venture with a South African company, Pepsi officials specifically noted that it intended to use South Africa as a "springboard" into the region. *See* note 533 and accompanying text, *infra.*

[47] Established in 1969 the Overseas Private Investment Corporation ("OPIC") is an executive agency that provides risk insurance and lends equity capital to U.S. investors and companies seeking to invest in developing countries. For a discussion of its development, *see* Theodor Meron, Note, *OPIC investment is alive and well,* 73 Am. J. Int'l L., 104 (1979).

support network for South African investments is also growing in the private sector, including the probable formation of a U.S.-South Africa business council.[49] Commercial lending activity is increasing, and a regional development bank may emerge.[50]

The competition for South Africa's domestic markets is expected to be fierce.[51] In fact, many European MNCs have been reinvesting in South Africa since 1991. Although some U.S. trade and investment bans were removed then, the remaining sanctions continued until late 1993.[52] Thus, in the search for promising local companies in which to acquire or establish joint ventures with, American manufacturing MNCs may already be at a competitive disadvantage as European and Asian competitors have had in effect a two year headstart.

On top of these marketborne disadvantages, U.S. MNCs are likely to encounter higher tax costs due to the different sets of planning considerations that arise from interest expense regulations under U.S. tax law and South African regulations of foreign investment. Hence before delving into the significance the interest expense rules have on the international investment behavior of U.S. MNCs, the overall strategy and specific objectives of such corporations are briefly noted.

B. *Multinational Corporate Strategy*

As the term suggests, multinational corporations operate in various countries, with the parent corporation residing in the

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48 Kaslow, *supra* note 38, at 9. In November 1993 the TEC negotiated an investment agreement with OPIC. *U.S., S. Africa sign deal on investment assistance,* Reuter Newswire, Nov. 30, 1993, *available in* LEXIS, Nexis Library, INTNEWS File. The OPIC began meeting with South African officials and American investors interested in South Africa in May 1992. *Southern Africa Monitor,* Afr. Econ. Dig., May 4, 1992, at 9. One of OPIC's programs, Africa Growth Fund, is 'privately owned and managed by banks and other interests which invest in the fund,' with OPIC extending risk insurance to it. President Clinton has specifically geared OPIC as a conduit of American foreign investment in several 'strategic' markets. *U.S. Investors Abroad to Benefit from OPIC's New Rule,* J. Com., Oct. 29, 1993, at 1A.

49 Richard Lawrence, *U.S., S. Africa Strengthening Their Bilateral Trade Links,* J. Com., June 2, 1994, at 2A.

50 Rosalind Rachid, *Mandela gets boost from U.S. business,* J. Com., at 1A.

51 Mark Solomon, *Return to South Africa seen Rough for U.S. firms,* J. Com., at 4B.

52 *See* notes 432-461 and accompanying text, *infra.*

'home' country while their foreign affiliates[53] conduct business in 'host' countries.[54] MNCs are typically conceptualized as "a combination of companies of different nationality, connected by means of shareholdings, managerial control or contract and constituting an economic unit."[55] Such corporations are uniquely powerful organizations[56] as their tremendous financial resources and sophisticated operating structures provide both economies of scale and of scope in producing, marketing and transporting goods throughout the world.[57] In fact, in 1980 the size of the annual product of two oil MNCs, Exxon and Royal Dutch/Shell, ranked the higher than that of South Africa.[58]

In pursuing market expansion and product diversification on a global scale, the parent corporations of U.S. MNCs undertake various types investments to ensure longterm financial stability.[59] All investments made by MNCs are products of business strategy, with the specific goals of investment set against a mix of financial, tax and managerial considerations.[60] While

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[53] For purposes of this article, the term 'affiliate' refers to companies that operate in foreign jurisdictions and which a U.S. corporate shareholder owns at least 5 percent of the affiliate's voting stock. *See* "Affiliate company," Black's Law Dictionary 58 (6th ed. 1990).

[54] Except for substituting 'multinational' with 'transnational,' the homehost dichotomy is the terminology employed by the United Nations Centre on Transnational Corporations ("UNCTC"). *See generally* UNCTC, TRANSNATIONAL CORPORATIONS IN WORLD DEVELOPMENT (1983).

[55] CLIVE M. SCHMITTHOFF, SCHMITTHOFF'S EXPORT TRADE 271 (8th ed. 1986)(hereinafter "Schmitthoff"), *quoting* Clive M. Schmitthoff, Nationalism and Multinational Enterprise 24 (C. Schmitthoff ed., 1973).

[56] The literature on multinational and transnational corporations is massive. For a concise review of the various themes within this literature, *see* D. K. Fieldhouse, *The multinational: a critique of a concept,* in MULTINATIONAL ENTERPRISE IN HISTORICAL PERSPECTIVE 929 (A. Teichova et al., eds., 1986).

[57] Economies of scale enable MNCs to handle a variety of investment types while economies of scope permit such corporations to structure single investments that are capable of 'supporting multiple profitable activities.' ALAN C. SHAPIRO, MULTINATIONAL FINANCIAL MANAGEMENT, 521-22 (3rd ed., 1989)(hereinafter "Shapiro").

[58] Jacqueline Matthews, *Multinational Corporations in SADCC (Southern African Development Coordination Conference),* in BANKING AND BUSINESS IN SOUTH AFRICA 159 (S. Jones ed., 1988), *citing* WORLD BANK ATLAS, (1983).

[59] For a brief description of the various kinds of investments *see* Daniels, *supra* note 6, at 405-427.

[60] *See generally* DOUGLAS WOOD & JAMES BYRNE, INTERNATIONAL BUSINESS FINANCE, (1981)(hereinafter "Wood & Byrne").

profit maximization is the overall aim,[61] the strategy of a particular investment may extend beyond pure financial gain.[62] In acquiring a foreign business, the parent corporation considers an array of business factors such as the "locus of legal liability, public image in the host country, managerial incentive considerations, and local legal and political requirements."[63] In short, "planning an acquisition requires evaluating the target as a controllable subset of the parent."[64]

Whereas tax considerations usually occupy a secondary analytical level in domestic acquisitions,[65] tax planning assumes greater significance when international operations are involved[66] as both home and host countries assert tax jurisdiction over the same business activity.[67] Reducing the incidence of international double taxation is therefore a universal objective among MNCs, with most industrial countries providing one of two models of relief for their resident corporations.[68] The exemption model excludes all or portions of income that is generated overseas and repatriated to resident corporations[69] while the credit model taxes the overseas income of resident corporations but allows the taxpayer to credit some or all of the foreign taxes it pays in the host country.[70] In short, the planning of

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61 Daniels, *supra* note 6, at 20.

62 For example, the U.S. parent may invest in a market simply to secure raw materials for distribution among its related companies.

63 DAVID K. EITEMAN & ARTHUR I. STONEHILL, MULTINATIONAL BUSINESS FINANCE, 648 (4th ed. 1986).

64 JOHN P. KARALAIS, INTERNATIONAL JOINT VENTURES: A PRACTICAL GUIDE, § 1.15 (1992).

65 *See* HENRY MINTZBERG & ROBERT M. JAMES, THE STRATEGY PROCESS (1988).

66 International Monetary Fund, "Tax Policy and Reform fore Foreign Investment in Developing Countries," in *Taxation and International Capital Flows,* (Organisation for Economic Cooperation and Development, comp. 1990), 163-192, at 171 (hereinafter "International Capital Flows").

67 *See* T. Modibo Ocran, *Double Taxation Treaties and Transnational Investment: A Comparative Study,* 2 Transnat'l Law. 131, at 133 (1989)(hereinafter "Ocran").

68 Richard D. Teigen, *"International Taxation: A Guide for U.S. Corporations,"* 18 Wm. Mitchell L. Rev. 291, at 293 (1992)(hereinafter "Teigen").

69 Yoseph Edrey & Adrienne Jeffrey, *Taxation of International Activity: Over Relief from Double Taxation Under the U.S. Tax System,* 9 Int'l Tax & Bus. Law. 101, at 105 (1991)(hereinafter "Edrey & Jeffrey").

70 *Id.* at 107.

international investments demand a solid understanding of the tax saving provisions afforded by the relevant jurisdictions.[71]

In entering new markets, manufacturing MNCs may organize an overseas operation according to a variety of legal entities, from nonequity arrangements, such as shortterm licensing or distribution agreements, to longterm local production and assembly plants.[72] However, tax authorities of both home and host countries place on top of these entities distinctions which have no effect on business operations but nonetheless significantly affect the business' total operating costs through differences in tax charges.[73] Hence the basic distinctions the Internal Revenue Service ("the Service") employs in taxing the global activities of U.S. MNCs are noted below.

C. *Taxing U.S. MNCs*

Like most countries, the U.S. tax law does not attach a statutory meaning to the term multinational corporation. Instead, the United States taxes resident corporations[74] on their worldwide incomes.[75] This is done by dividing gross income into two broad categories, domestic source income and foreign source income.[76] Domestic source income is taxed currently, while foreign source income is generally not taxed until it is remitted to the United States in a taxable form, such as dividends, interest payments, or royalties.[77] However, certain types of foreign source income are taxed currently by virtue of the level or type of ownership interest the U.S. taxpayer has in a foreign entity

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71 *See* Gregg D. Lemein & Debra Falduto Novack, *International Mergers and Acquisitions,* 67 Taxes 844 (1989)(hereinafter cited as "Lemein & Novack").

72 STEFAN H. ROBOCK & KENNETH SIMMONDS, INTERNATIONAL BUSINESS AND MULTINATIONAL ENTERPRISES, 214 (4th ed., 1989)("Robock & Simmonds").

73 Entity classification is organized by I.R.C. § 7701 & Treas. Regs. §§ 1.301.77011(c) and 301.77012.

74 I.R.C. § 7701(a)(4) (1986). Nonresidents corporations are taxed on U.S. source income and income deemed to be 'effectively connected' with a U.S. trade or business. I.R.C. § 881(a), 882(a)(1).

75 I.R.C. § 61(a).

76 Because I.R.C. § 61(a) defines gross income as "all income from whatever source derived," the income sourcing rules of §§ 861865 divide income from each category 'according to type.' JOSEPH ISENBERGH, 1 INTERNATIONAL TAXATION, 94 (1990)(hereinafter "1 Isenbergh"). *See also* ROBERT A. RAGLAND, TAXATION OF FOREIGN SOURCE INCOME (1990).

77 Teigen, *supra* note 68, at 329.

and the nature of income itself (active or passive). Such rules, called Subpart F, are more fully discussed in later sections.[78]

Deductions must also be sourced to an activity that gives rise to a taxable event.[79] Treasury Regulation § 1.8618 'guides the assignment of expenses to foreign or domestic income'[80] by directly allocating those expenses which are connected with a particular class of gross income.[81] As there are several statutory groupings[82] within a class, the allocated expenses are then apportioned among those groupings as such expense were incurred.[83] Expenses that can be traced to all classes of income within the class are apportioned to all gross income.[84]

Under the I.R.C. the concept that comes closest to the multinational corporation as it is commonly understood is that of the "affiliated group," which is a group of domestic corporations or possessions that are connected by at least 80% stock ownership to a common parent.[85] Such groups may file a consolidated tax return for all U.S. entities therein.[86]

This Comment discusses some of the difficulties the U.S. parent of manufacturing MNCs is likely to encounter in investing in South Africa via a foreign subsidiary or a joint venture. This focus was chosen because foreign subsidiary is the entity wherein "almost two thirds of U.S. exports" are funneled.[87]

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78 *See* notes and accompanying text, *infra*.

79 U.S. tax jurisdiction is based on an 'economic nexus' approach which, generally speaking, recognizes expenses as deductions only when the expenses are attached to the very income in which they were incurred to produce. Alan Wilensky, *Future Directions of U.S. International Tax Policy*, 70 Taxes 998, at 1005 (1993) [hereinafter "Wilensky"].

80 *Id.*

81 Treas. Reg.. § 1.8618(a)(2).

82 The statutory grouping of gross income is the gross income from a specific source of activity, which must be determined before arriving at taxable income from the specific source or activity under an operative section. *Id.*

83 Temp. Treas. Reg.. § 1.8618T(c)(1).

84 Treas. Reg. § 1.8618(b)(1).

85 I.R.C. § 1504(a).

86 A single, consolidated tax return can be filed by corporations of an affiliated group under §§ 1501-1505 of the Internal Revenue Code and § 1.15024 of the Treasury Regulations.

87 Statement of Peter Merrill, Price Waterhouse, representing the U.S. Multinational Corporation Tax Policy Coalition before the House Ways and Means Subcommittee on Select Revenue Measures, September 21, 1993, Tax Notes Today, September 22, 1993, *available in* LEXIS, FEDTAX Library TAXANA File.

Likewise, foreign joint ventures[88] have recently become a strategic means for U.S. MNCs to 'crack new markets,'[89] as such ventures permit U.S. MNCs to enter new markets without incurring the type of resource commitment that typically accompanies the establishment of foreign subsidiaries.[90] It is assumed that many manufacturing U.S. MNCs will consider these entities, among others, in evaluating the prospects of profitable business investment in South Africa.

1. *Foreign Subsidiaries.*

Foreign subsidiaries are incorporated in jurisdictions other than the Unites States and its possessions and thus stand as a separate legal entities.[91] Earnings and profits accrued by the subsidiary are generally not subject to U.S. taxation until they are remitted to the U.S. as dividends, rents, royalties, interest payments or other categories.

The two main types of subsidiaries in U.S. tax law are that of the minority owned foreign subsidiaries, referred to here as "10/50" subsidiaries, and "controlled foreign corporation" (CFC) varieties. In the former, the U.S. parent holds an interest that is at least 10% but not greater than 50% of the company.[92] As noted, the earnings and profits of minorityowned U.S. subsidiaries in most instances are not taxed until they are repatriated to the U.S. shareholder. Deferring the inclusion of the earnings of foreign subsidiaries provides U.S. corporate shareholder an opportunity to reduce includible foreign source income by the time value of the effective tax rates in the relevant jurisdictions.[93]

Wholly owned subsidiaries or CFCs,[94] on the other hand, are corporations which operate in countries other than the one

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[88] The term 'foreign joint venture' encompasses various investment relationships where the venture's equity is divided between at least two private companies. Daniels, *supra* note 6, at 9.

[89] Wysocki, *CrossBorder Alliances Become Favorite Way to Crack New Markets,* Wall St. J., Mar. 26, 1990, at 1.

[90] Robock & Simmonds, *supra* note 72, at 215.

[91] I.R.C. § 7701(a)(5)(1986).

[92] This term draws from the revised foreign tax credit limitations, as noted *infra.*

[93] ISENBERGH, 2 INTERNATIONAL TAXATION, 20 (1990).

[94] M.W. E. GLAUTIER, A REFERENCE GUIDE TO INTERNATIONAL TAXATION, 28 (1987).

in which their ownership is controlled.[95] Under U.S. tax law, a foreign subsidiary is a CFC when all combined 'U.S. shareholders' hold a total of 50% or more of the vote or stock.[96] In turn, a U.S. shareholder is a U.S. person or corporation that owns at least 10% of the total combined voting power of the stock in a foreign subsidiary.[97] Thus if a U.S. multinational owns either 'directly, indirectly or constructively over 50% of the vote or value' of a foreign subsidiary, the subsidiary is deemed to be related to the U.S. MNC as a controlled foreign corporation.[98]

CFC status carries forth an array of complex tax provisions, including rules designed "[t]o prevent U.S. corporations from artificially shifting profits from international operations to their foreign subsidiaries via 'transfer pricing.'"[99] Rules known as Subpart F currently tax the 10% CFC shareholders on certain types of 'tainted income,[100] which includes, among others,[101] income from insurance and various kinds of foreign base company income.[102]

2. *Foreign Joint Ventures*

Foreign joint ventures are typically formed through property transfers, namely assets or stock, among or between a group of previously unrelated corporations.[103] If the new entity

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95 DELOITTE TOUCHE TOHMATSU, SOUTH AFRICA, 94 (1993)("hereinafter "Deloitte, Touche, Tohmatsu").

96 I.R.C. § 957(a).

97 I.R.C. § 951(b).

98 Alan S. Lederman & Bobb Hirsh, *The CFC Netting Rule Entangles U.S.based Multinationals,* 3 J. Int'l Tax'n 69, 70 (1992)(hereinafter "Lederman & Hirsh").

99 Karl William Viehe & Donald T. Williamson, *Tax Issues in Planning Transnational Transactions-The U.S. Perspective,* 2 Transnat'l Law. 93, 107 (1989)(hereinafter "Viehe & Williamson").

100 I.R.C. § 951(a)(1).

101 For a concise review, *see* Teigen, *supra* note 68, at 33644.

102 Under § 954, a 'foreign base company income' includes income from generated services, shipping income, oilrelated activities, and sales of goods to and/or from related parties in any country other than where the party is incorporated. Also included is income from foreign personal holding companies. ANNAMARIA RAPAKKO, BASE COMPANY TAXATION, 16 (1989).

103 J. FRED WESTON et al., MERGERS, RESTRUCTURING, AND CORPORATE CONTROL, 738 (1990)(hereinafter "Weston et al.").

holds the transferred property as an incorporated company,[104] then the transferors are subject to strict non-recognition rules on any gain in the property transferred.[105] The Service determines whether a particular foreign joint venture will be taxed as a partnership or corporation,[106] although it defers to the law of the host country in discerning the 'legal relationships among the venturers, between the venturers and the public and control of the venture's assets.'[107] The difference is significant. If the joint venture is structured as a foreign corporation in which the U.S. venturer holds a minority share, the U.S. shareholder is taxed at the corporate rate on the venture's remitted earnings. If the venture obtains CFC status, either initially or after other U.S. interests are brought into it, the joint venture is subject to Subpart F treatment and is taxed currently on the passive income.[108] In either case dividends received from a foreign joint venture enjoy favorable foreign tax credit treatment.[109]

On the other hand, a joint venture structured as a partnership enables the U.S. corporate venturer to capture the tax advantages that exist under Subchapter K.[110] To be considered a foreign partnership for U.S. tax purposes, the foreign joint venture must lack at least two of the four main corporate characteristics, namely continuity of life, free transferability of interests, limited liability and centralization of management.[111] A venture so structured is treated as a passthrough entity, one that escapes corporate taxes as the venture's activities are deemed

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104 For a discussion of U.S. taxation of foreign joint ventures, *see* Bruce N. Davis & Steven R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 Tax L. Rev. 165 (1991) (hereinafter "Davis & Lainoff").

105 I.R.C §§ 351, 367(a).

106 I.R.C. § 7701 and Treas. Regs. §§ 301.77011(c), 301.77012.

107 Davis & Lainoff, *supra* note 104.

108 D. Kevin Dolan, *"Special Issues in Structuring International Joint Ventures,"* 345 PLI/Tax 447 (1993), *available in* WESTLAW TXTP Database (hereinafter "Dolan 1993").

109 The venture's dividends escape the separate limitation baskets of § 904, as discussed in Part II.B.1, *infra*.

110 *See* Louis S. Freeman & Thomas M. Stephens, *Using a Partnership When a Corporation Won't Do: The Strategic Use and Effects of Partnerships to Conduct Joint Ventures and Other Major Corporate Business Activities*, 68 Taxes 962 (Dec. 1990).

111 There is indication that the Service will interpret the absence of continuity of life and free transferability of interests as sufficient for partnership status. Alan P. Parnes, *United States Tax Considerations in Organizing a Foreign Joint Venture*, 20 J. Corp. Tax'n 3, 8 (1993)(hereinafter "Parnes").

to be directly attributable to the U.S. corporate venturer.[112] The amounts of income, deductions and credits allocatable to each partner is determined by the partnership agreement.[113] A joint venture organized as a partnership also allows the U.S. venturer to avoid the severe recognition rules which accompany the contribution of property for joint venturers structured as corporations.[114]

With these considerations in mind, attention now shifts to some of the ways U.S. parent corporations acquire and structure overseas businesses. For ease in presentation, the term 'U.S. parent' hereinafter refers to the U.S. corporate shareholder that acquires or establishes a 'target,' which refers to an existing South African company or one that is formed with the U.S. parent.

3. *Financing Overseas Operations*

Just as there are many ways to skin a cat, so too are the means by which U.S. parents acquire overseas companies both numerous and unique.[115] This discussion centers on what is perhaps the traditional method of corporate acquisition direct purchase of stocks or assets. Hence the intricate ways of indirect acquisition through foreign 'finance' or 'holding' companies[116] and the plethora of currency issues that accompany international investments have been left for more capable hands.[117]

Direct acquisitions divide into three broad categories: equity financing, debt-based financing and inter-company financ-

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112 Allen Friedman, *U.S. Tax Considerations in Choosing an Entity to Hold Foreign Business Operations,* 46 Tax Law. 15, 22 (1991)(hereinafter "Friedman").

113 I.R.C. § 704(a). Under § 482, the Service may subject the U.S. shareholder to greater proportion of taxation on the venture's operations if it deems the shareholder to have 'common control' of the venture. *See* Barrett & Rafferty, *Section 482 and Nonrecognition Transfers,* 45 Tax Notes 1239 (1989).

114 I.R.C. § 721.

115 For an excellent introductory discussion, *see* JULIAN S. ALWORTH, THE FINANCE, INVESTMENT AND TAXATION DECISIONS OF MULTINATIONALS, (1988).

116 For an introductory discussion, *see* Wood & Byrne, *supra* note 60, at 170-174.

117 For concise treatment of these topics, *see generally* SURENDRA K. KAUSHIK & LAWRENCE M. KRACHOV, MULTINATIONAL FINANCIAL MANAGEMENT (1989)(hereinafter "Kaushik & Krachov").

ing.[118] In addition to its impact on the parent's global tax costs, the choice of acquisition method shapes the target's initial capital structure and operating costs. Hence in capitalizing an overseas operation, the parent's financial managers must determine an appropriate debt-to-equity ratio for the acquired affiliate to carry.[119] This ratio, the financial underpinning of any business, will influence not only the initial acquisition method but subsequent decisions as well, such as the distribution of earnings.[120]

Equity acquisitions involve the transfer of stocks from the parent to the target in exchange for a controlling interest in the target's voting stock. Under this method, U.S. tax liabilities do not arise until the parent sells the acquired stock, at which time the stock's basis will determine whether the parent accrued any capital gains on the transfer.[121] Otherwise, earnings and profits retained by the affiliate increase the stock's taxable basis.[122] Also, stock in an overseas business may be deemed as "foreign assets" for various U.S. tax computations, including the foreign tax credit election.[123]

Debt-based acquisitions involve the purchase of assets such as physical plant, real estate or even other debt obligations, through the use of a debt obligation. Such transactions occur by way of loans from thirdparty commercial lenders, debt instruments in international monetary markets, such as Euromoney and Eurobonds, or through the issuance of corporate bonds.[124] Additionally, this type of borrowing can occur at three levels within the MNC: at the level of the U.S. corporate group, at the

[118] For an excellent overview of international acquisitions, *see* William G. Cavanagh & Leslie J. Schreyer, *U.S. Acquisitions of Foreign Corporations: selected issues*, 281 Prac. Law Inst. Tax. 7 (1989), *available in* WESTLAW, TXTP Database (hereinafter "Cavanagh & Schreyer").

[119] International Capital Flows, *supra* note 66, at 173-74.

[120] SIDNEY M. ROBBINS & ROBERT B. STOBAUGH, MONEY IN THE MULTINATIONAL ENTERPRISE, 51 (1973)(hereinafter "Robbins & Stobaugh").

[121] There are exceptions, as 'stock transfers to foreign jurisdiction for the purposes of establishing a corporate joint venture are only tax free if the U.S. shareholder holds less than 5% of the venture's voting stock or if holding 5% or more, the U.S. shareholder enters into a share a gain recognition agreement. Davis & Lainoff, *supra* note 105, at 170.

[122] Dolan 1993, *supra* note 108.

[123] Temp. Treas. Reg. § 1.86112T(c).

[124] Shapiro, *supra* note 57, at 656-676.

level of the foreign corporate group within the same MNC or at the level of the foreign target itself.

Finally, the multinational is itself a source of funding for both the acquisition of foreign companies and financing the later's working capital requirements. Inter-company financing occurs whenever the U.S. parent or 'sister' affiliates[125] within the corporate group secures a loan from a thirdparty lender and then 'onlends' or transfers the loan proceeds to its affiliate as a debt obligation. Thereafter, the affiliate makes interest payments to the parent while the parent pays interest to the original lender.[126] Overall inter-company lending has served as an "effective means of cash management" where local finance is scarce.[127] The interest payments make it easier for the affiliate to repatriate earnings to the United States because "dividend payments and reduction in [the affiliate's] capital stock are characteristically more closely controlled by governmental regulations than are principal and interest payments."[128]

Of course the choice of acquisition method is drawn from a mix of factors, including the types of income the parent wants the acquired business to develop. Generally, debtfinanced acquisitions are preferred over stockbased acquisitions because such transactions take less time to complete and establish a fixed amount of interest payable over for a specified period.[129] Debt also reduces 'cash buildups' within the subsidiary, thus preserving the tax basis of original stock.[130] Equity financing, on the other hand, reduces the parent's total stock holdings at the moment of the transfer, jeopardizing (at least theoretically) the corporation's financial stability.[131]

A key issue is whether interest expense incurred in acquiring the target can be divided among the parent and target so as

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125 A sister corporation to an affiliate is defined as one that has "common of substantially common ownership by same shareholders." Black's Law Dictionary 1387 (6th ed. 1990).

126 Joseph L. Andrus, Robert H. Dilworth & Jeffrey M. O'Donnell, *U.S. Tax Considerations in Financing Foreign Subsidiaries*, 68 Taxes 683, 703 (hereinafter "Andrus et al.").

127 Lederman & Hirsh, *supra* note 98.

128 Robbins & Stobaugh, *supra* note 120, at 50-51.

129 John Livingston, Comment, *Corporate Tax Integration in the United States: A Review of the Treasury's Integration Study*, 58 Mo. L. Rev. 717, at 719-20 (1993).

130 Kaushik & Krachov, *supra* note 117, at 99.

131 Friedman, *supra* note 112.

to minimize global tax costs.[132] Placing debt 'downstream' or onto the target occurs when the parent acquires only a part of the target's assets, leaving the target to secure additional loans to purchase outstanding stock or additional assets.[133] Since the affiliate's subsequent earnings are used to repay the loan, the value of the affiliate's stock held by the U.S. parent is reduced. Capitalizing the foreign affiliate in this manner generally occurs only when the acquired company is permitted to deduct its interest payments on the acquisition debt.

However the affiliate is acquired or established, the parent's financial managers must also consider the affiliate's working capital requirements. Again the focus of this discussion is limited to local financing and inter-company financing. Local financing is perhaps the most frequently used method, as it is often easier and cheaper for the affiliate to obtain loans given its local credit rating than to request lending from related or nonrelated sources outside the host country.[134] Local financing can also lessen the impact foreign exchange fluctuations and inflationary risks visit upon the affiliate.[135]

The tax treatment of inter-company loans can differ significantly between home and host jurisdictions. In the home country, regulations may require limitations on the loan amount and a minimum or arm's length interest rate Conversely, the host country may limit the maximum rate of interest and impose withholding taxes on interest payments paid to related parties. Still, the withholding tax rate may be lower than the applicable U.S. income tax rate or a double taxation treaty may lower or eliminate such taxes altogether.[136] In all the choice of post-acquisition financing frequently involves a comparison of the debttoequity requirements of the local and foreign lenders, knowledge of the host country's equity limitations and tax consequences, and an understanding of an equally complex set of currency issues.[137]

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132 Kingson 1992, *supra* note 36, *at*, 1766.

133 Cavanagh & Schreyer, *supra* note 118, at III(B)(1)(b).

134 Robbins & Stobaugh, *supra* note 120, at 6465.

135 Robock & Simmonds, *supra* note 72, at 544

136 Shapiro, *supra* note 57, at 370.

137 Robock & Simmonds, *supra* note 72, at 546.

Contingent to all debtbased transactions in the present context is the deductibility of interest expense in both the U.S. and in the host country. In the ledgers of most U.S. manufacturing MNCs, interest expense stands as one of the largest expenditures. The allocation and apportionment of interest expense within an affiliated corporate group is one area in U.S. tax law where the interplay of foreign tax provisions can significantly alter the attractiveness of overseas investments.[138] This is due to the complexity of the new interest expense allocation and apportionment rules, which have not only created a "cottage industry"[139] for international tax attorneys but, more fundamentally, revised the planning objectives for most U.S. MNCs, especially with respect to the financing of overseas operations.[140]

Obviously, foreign taxes stand as the chief expense for U.S. MNCs. Part II details the changes TRA 1986 introduced in both the foreign tax credit election and interest expense rules and discusses their general impact on the international tax planning for U.S. manufacturing MNCs.

PART II. INTEREST EXPENSE, FOREIGN TAX CREDITS AND U.S MNCs

Although seven types of interest expense are defined in the I.R.C.,[141] only one trade or business interest[142] occupies our attention. Business interest may be thought of as the cost of borrowing funds which are needed to meet the corporation's

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138 Joseph L. Andrus, *Planning Under U.S. Expense Allocation Rules,* 70 Taxes 1008, 1008 (1992) (hereinafter "Andrus 1992").

139 Charles Kingson, *Foreign Tax Credit and Its Critics,* 9 Am. J. Tax Pol'y 1, 5 (1991) (hereinafter referred to as "Kingson 1991").

140 Andrus 1992, *supra* note 138, at 1018.

141 Seven categories of interest expense: investment interest, passive activity interest, personal interest, portfolio interest, qualified residence interest, and trade or business interest. For a good discussion of interest expense under § 163 and the accompanying regulations, *see* Deborah Whitt, *Interest Deductions after the Tax Reform Act of 1986 and the Revenue Act of 1987,* 6 B.U.J. Tax Law 85 (1988)(hereinafter "Whitt").

142 " 'Trade or business expenditure' means an expenditure (other an a passive activity expenditure or an investment expenditure) in connection with the conduct of any trade or business other than the trade or business of performing services as an employee. Temp Treas. Reg. § 1.1638T(b)(7). *See also* Whitt, *supra* note 141, at 109, note 161.

ongoing capital requirements.[143] As noted business interest represents a significant portion of a corporation's recurrent expenditures and thus a critical area for tax planning. Periodically, however, even judiciously planned corporate expense schedules are thrown a curve by substantial changes in tax law. This is precisely what happened after the 1986 legislation.

TRA 1986 was borne in the interest of protecting the U.S. tax base from being eroded by the worldwide activities of U.S. corporations.[144] It brought forth significant changes in expense allocations among affiliate corporate groups and the crediting of foreign taxes paid or deemed paid by the U.S. parents of such groups.[145] Its primary reforms involved a substantial lowering of maximum corporate tax rate, adding four income baskets to § 904(d) foreign tax credit limitation scheme and enacting an entirely new interest allocation methodology through the introduction of § 864(e). Together, these changes have "fundamentally altered the economics of international acquisitions by U.S. or U.S.owned persons."[146]

A. *Lower Corporate Tax Rate*

Perhaps the most conspicuous change lies in the lowering of the maximum marginal corporate income tax rate from 46% to 34% (now 35%).[147] Since the rate is one of the lowest in the industrialized world, this change almost assures that a parent's foreign tax liability on foreignsource income will exceed its U.S tax liability on the same income.[148] Additionally, the lower rate yields an interest deduction that in effect 'gives as a maximum tax benefit 35 cents per dollar of interest expense.'[149] That is,

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143 Andrus, *supra* note 138, at 1018.

144 Richard M. Hammer & Wesley N. Riemer, *Coping with Separate Foreign Tax Credit Limitations,* 1 J. Int'l Tax'n 5, at 5 (1990)(hereinafter "Hammer & Riemer").

145 Virginia M. Tarris, *Foreign Tax Credit Limitation After Tax Reform: The Separate Limitation Categories and the Application of the Lookthrough Rule,* 42 Tax Law. 275, at 275 (1989).

146 Cavanagh & Schreyer, *supra* note 11.

147 The Revenue Reconciliation Act of 1993 raised the corporate rate to 35%.

148 Ernest R. Larkins, *International Commerce Through a Foreign Subsidiary: Navigating the Anti-Haven Tax Shoals of the Internal Revenue Code,* 9 Int'l Tax & Bus. Law. 64, at 83 (1991)(hereinafter "Larkins").

149 Andrus et al., *supra* note 126, at 687.

there could be a loss in the amount of a deduction or credit whenever the foreign tax rate exceeds 35%.

In order to fully understand the impact of the changes in the treatment of interest expense, it is necessary to first explain the changes that were made with respect to the foreign tax credit election.

B. *Changes in the Foreign Tax Credit Election*

Because the earnings and profits of overseas operations can be taxed in the U.S. as well as in the country in which it is generated, U.S. corporations may either credit or deduct all or portions of taxes paid in foreign jurisdictions. As a deduction, paid foreign taxes reduce the amount of taxable foreign source income.[150] Because this choice simply lowers the marginal tax rate applied to foreign source income,[151] the foreign tax deduction election is an ineffective means of controlling double taxation for most MNCs.

In contrast, the foreign tax credit, embodied in I.R.C. §§ 901-908, provides a dollarfordollar reduction in the amount of U.S. taxes owed on foreign source income.[152] The difference is substantial in that it is possible to completely offset U.S taxes on foreign source income by claiming foreign tax credits to the maximum allowable under § 904.[153]

This election[154] operates on two basic principles. U.S. corporations may credit the foreign taxes paid or deemed to have

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150 I.R.C. § 164(a)(3).

151 If a U.S. corporation has $100 in foreign source income and has paid $20 in foreign taxes on that income, the amount of U.S. income tax on the same income is $28, which is 35% of the $80 (amount of taxable income less the deduction). The marginal tax rate on the $100 of foreign source income is then 48%, as opposed to a combined tax rate of 55% if a deduction was not permitted.

152 I.R.C. 901(b). Upon using the foreign tax credit election, a corporation is not permitted to deduct foreign taxes under I.R.C. § 275(a)(4)(A).

153 If a U.S. corporation pays $35 in foreign taxes in a country in which it generates $100 of foreign source income, the U.S. income tax liability of $35 on that $100 of foreign source income is wiped out by the $35 of foreign tax credits. If the foreign tax rate is less than or equal to the applicable U.S. tax rate, the marginal tax remains the same as the U.S. corporate rate. When the foreign tax rate exceeds the U.S. rate, the overall amount of taxes paid by the corporation on foreign source income will, in most situations, remain lower by crediting foreign taxes as opposed to deducting foreign taxes.

154 I.R.C. § 901(a).

been paid[155] by all of its foreign subsidiaries in which it holds at least a 10% interest in stock (first tier corporations) and a percentage of the taxes paid by foreign corporations (second tier corporations) which are themselves at least 10% owned by the firsttier foreign subsidiary.[156] Deemed paid foreign tax credits relate to the receipt of remitted foreign source income. Because earnings generated by foreign subsidiaries are not taxable until remitted as dividends to the parent corporation, only those taxes which were paid by the subsidiary in generating and remitting such dividends may be used by the parent corporation to offset its U.S. tax liabilities in receiving the dividends.[157] Secondly, a U.S. corporation cannot use income taxes paid in a foreign country to reduce its U.S. income taxes on domestic source income. In short, the foreign tax credits "cannot exceed the U.S. tax that it offsets."[158]

As such, § 904(a) limits the amount of foreign taxes which can be credited against the amount of U.S. tax owed on foreign-source income.[159] A few years after Congress enacted the foreign tax credit election in 1918,[160] an overall limitation was established. That framework continues today, as § 904(d) limits the crediting of foreign taxes to the lesser of either a) the actual amount of foreign taxes paid or deemed paid or b) by the "ratio of that foreignsource income bears to worldwide income multiplied by the U.S. income taxes on worldwide income."[161] For the latter, the limitation formula computes as

[155] Treas. Reg. § 1.9011(c). Under § 902, a U.S. parent is deemed to have paid a portion of the foreign taxes of a 10% foreign subsidiary. This portion is derived by referring to the same dividendtoundistributed earnings ratio that the subsidiary used in remitting dividends to the U.S. parent. Philip McGovern, *Joint Application of Section 304 and Subpart F Offers Foreign Tax Credit Planning Opportunities,* 19 Int'l Tax J. 7, 11 (1993).

[156] Viehe & Williamson, *supra* note 99, at 101.

[157] I.R.C. § 902.

[158] 1 Isenbergh, *supra* note 76, at 483.

[159] I.R.C. § 904(a).

[160] For a discussion of the foreign tax credit election and permutations it has undergone during its seventysix year history, *see* 1 Isenbergh, *supra* note 76, at 471-81.

[161] W. Theodore Kresge & Timothy Jay Throndson, *IRS' Third Try AT CFC Netting Regulations,* J. Int'l Tax'n 156, at 156 (1991)(hereinafter "Kesge & Throndson").

$$\text{FTC limitation} = \frac{\text{Foreign Source Taxable Inc}}{\text{Worldwide Taxable Inc.}} \times \text{(precredit U.S. tax on worldwide income)}$$

A brief example illustrates how the limitation merely caps the amount of credits that can be used against U.S. tax liability on foreign source income. Assume a U.S. parent corporation had, in 1983, $500 of domestic source income and $500 of foreign source income, for a total of $1,000 in worldwide income. Tentative tax on its worldwide income at the previous tax rate of 46% would have been $460 ($1,000 × .46). The maximum amount of foreign tax credits which could have been credited against this precredit tax liability was $230 (($500/$1,000) × $460). Thus, if the U.S. parent paid a total of $250 in creditable foreign taxes on the $500 deemed as total foreign source income, only $230 of that could be used. The excess $20 ($250-$230) could be carried back two years or forward five years.[162]

Beginning in 1960, separate limitations were established for certain types of income or "baskets," such as non-business interest income.[163] However, the overall active income limitation of § 904 covered most types of overseas activities.[164] Except for these narrowly defined baskets, foreign source income from all overseas affiliates were lumped together to determine the total amount of foreign tax credits a U.S parent could use against its U.S. tax liability on foreign source income. This crediting scheme permitted excess foreign tax credits generated in a hightax jurisdiction to 'cross over' and be absorbed by the income from lowtax jurisdictions. By generating sources of foreign source income which were, on average, taxed at rates near the applicable U.S. rate, all of the credits in the general limitation basket could be used.[165]

Thus, in continuing the previous example, assume that the U.S. parent's total foreign source income ($500) came from two

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162 I.R.C. § 904(c).

163 D. Kevin Dolan & Carolyn M. DuPuy, *The Foreign Tax Credit Overview and Creditability Issues,* 901 Tax Managment § at A32 (hereinafter "Dolan & DuPuy").

164 Kingson 1991, *supra* note 10.

165 Virginia M.Tarris, *Foreign Tax Credit Limitation After Tax Reform: the Separate Limitation Categories and the Application of the LookThrough Rule,* 42 Tax Law. 275, at 275 (1989)(hereinafter "Tarris").

wholly owned subsidiaries operating in different countries.[166] Assume further that each subsidiary contributed an equal amount of foreign source income ($250) and that the foreign credit tax limitation was $230. If one subsidiary remitted active income that was taxed at a rate of 60% while the other remitted active income that was taxed at 40%, the combined amount of foreign taxes paid on the first remitted $500 would have been $250 ($150 on the first income ($250 × .60) plus $100 on the second ($250 × .40)).

It must be remembered that foreign tax credit limitation baskets set ceilings on the amount of foreign taxes which could be credited against U.S. tax liability. Obviously, these ceilings depend on the amount of foreignsource income placed therein. To determine the taxable foreignsource income, the foreign tax credit election requires the gross foreignsource income of each basket to be reduced by all deductions allocable to those limitation baskets.[167]

The limitation scheme has undergone several permutations over the years.[168] In 1976, the overall limitation was modified to permit the crediting of foreign taxes paid on certain types of foreignsource income, including interest income, according to the ratio those sources contributed to the U.S. parent's worldwide income.[169] This limited the application of foreign tax credits on such income sources to the U.S. effective income tax rate that would be imposed on the same income.[170]

Hence prior to 1987, three main principles organized the international tax planning for most U.S. MNCs. The overall goal was to raise the U.S. parent's general income foreign tax credit limitation by increasing the proportion of gross foreignsource income contributed to their worldwide incomes. A high foreignsource income to worldwide income ratio actually reduced U.S. tax liability on all repatriated income.

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[166] This example is drawn from Teigen, *supra* note 68, at 318.

[167] Kresge & Throndson, *supra* note 161, at 157.

[168] Between 1954 and 1976, taxpayers could chose to have their foreign tax credits computed by the basket limitations or on a per country basis. In 1976 the per country limitations were replaced. 1 Isenbergh, *supra* note 76, at 478.

[169] Joseph J. Czajkowski, *US foreign tax credit,* 6 Intertax 224, 228 (1989)(hereinafter "Czajkowski").

[170] 1 Isenbergh, *supra* note 76, at 532.

Secondly, timing the repatriation of foreign source income stood as an important planning feature. U.S. MNCs deferred inclusion of foreign source income until the parent accumulated sufficient foreign tax credits to offset inclusion of foreign source income from a particular source.

The third tax planning principle arose in response to changes made in 1984 when 'look through' treatment of § 904(d)(3) was introduced. At that time the look through rules excluded the dividends, interest and Subpart F inclusions of CFCs from the basket limitations and instead computed separate limitations for each type of income.[171] This change affected the blending of tax rates as such income is invariably taxed at rates lower than the rate imposed on active business. With these rules in mind, U.S. MNCs simply had their minority owned foreign subsidiaries generate the very types of income that otherwise would trigger separate basket treatment had a CFC generated such income.[172] Such adjustments not only avoided the separate basket limitations but also increased by the overall amount of foreign taxes creditable by lumping as much foreign source income into the activesource limitation. Hence in returning to the previous example, the U.S. parent would have computed a separate foreign tax credit limitation if one of the subsidiaries was a CFC. Dividends received from the nonCFC subsidiary would have gone into the general foreign source income category.

In an effort to prevent further erosion of the U.S. tax base, TRA 1986 significantly revamped the foreign tax credit election. Four baskets were added to the § 904(d) limitations, increasing the number of limitations baskets to nine. The second and most important change lies in the requirement that the limitation formula noted on page is to be made for each foreign tax credit income basket.[173] As such, the gross foreign source income of a U.S. parent can be, if applicable, divided into eight narrowly defined, 'separate limitation' baskets, with the rest falling into one 'residual' or 'general limitation' basket.[174] This all encompassing framework was bolstered by provisions that anticipate in-

[171] Czajkowski, *supra* note 169, at 229.
[172] Dolan & DuPuy, *supra* note 163, at A34.
[173] I.R.C. § 904(d)(2).
[174] Edrey & Jeffrey, *supra* note 70, at 115.

stances where items of income can be classified in several baskets, as noted below. Overall these changes were intended to prevent U.S. MNCs from investing overseas in order to maximize their foreign tax credit election.

The breadth of these changes lies in the enactment of several separate limitation baskets for a number of types of income which traditionally have been viewed as passive income. Hence the 'main' passive income basket of § 904(d)(2) extends the previous definition of non-business interest income to include the types of income associated as "personal holding company income."[175] However, this definition excludes active rents and royalties from unrelated person,[176] export financing income,[177] and "high tax kick out" income,[178] which is interest income that is taxed at an effective tax rate that exceeds the highest U.S. rate.[179] These exceptions were enacted to prevent 'the U.S. parent from blending hightaxed, foreignsource *passive* income with lowtaxed foreign source *passive* income' (emphasis added).[180]

Other types of passive income are now granted 'basket' treatment. High withholding tax interest is one of these creatures, as it captures any interest income received from a nonCFC foreign subsidiary which was subject to a withholding

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[175] In I.R.C. § 954(c)(1)(A)(E), foreign personal company holding interest is defined as dividends, net gains on certain property transactions involving no gain or passivelike gains, net gains from commodities, foreign currency gains, and net gains from certain foreign currency transactions. *See* Hammer & Riemer, *supra* note 144, at 6.

[176] Treas. Reg. § 1.9044(b)(2). These items are excluded from this basket because active trade or business may legitimately generate rent and royalty payments,and would be taxed at rates higher than what typically accompanies the creation of passive income. Hammer & Riemer, *supra* note 144, at 6.

[177] I.R.C. § 904(d)(A)(iii)(II); Treas Reg. § 1.90944(b)(1). This exception covers net gains derived from the financing of the sale of property by the taxpayer (e.g. U.S. parent) or related party that was manufactured or produced in the United States and was later used or consumed outside the U.S. This exception is also favorable to the taxpayer because such interest income is directly related to active trade or business and should not be characterized as an activity that is taxmotivated. Hence such income is placed in the residual basket. Hammer & Riemer, *supra* note 144, at 7.

[178] I.R.C. §§ 904(d)(2)(A)(iii)(III); 904(d)(2)(F); Treas. Reg. § 1.9044(c)(1).

[179] The exception removes what is otherwise passive income from this basket and places in the residual basket because of the high rate in which it was taxed. The Service determines whether such passive income warrantes the kick out exception after expenses are deducted from gross foreign income and effective tax rates are computed and compared. Hammer & Riemer, *supra* note 144, at 7.

[180] Teigen, *supra* note 68 at 320.

tax of 5% or higher.[181] Such interest income may actually be subject to a high effective tax rate if the withholding tax is imposed on gross interest income.[182] Similarly, the 'financial services income' constitutes a separate basket as well,[183] covering active income from banking, income from insurance investments, insurance income and income which is generated by financial dealings not covered by other baskets.[184]

A separate basket was also carved out for dividends received from *each* non-controlled § 902 corporation.[185] Such a corporation exists whenever the U.S. parent owns at least 10% of the voting power but not more than 50% of the voting power (10/50 subsidiaries). In requiring that the limitation is calculated for each subsidiary, this basket effectively prevents a U.S. parent from blending the tax rates of its network of 10/50 subsidiaries.[186] This change also affects the post-acquisition distributions of acquired companies, as dividends paid out by the company's pre-acquisition earnings fall into this basket.[187]

The remaining separate limitation baskets cover shipping income,[188] certain dividends from an existing or former Domestic International Sales Corporation,[189] certain distributions from a Foreign Sales Corporation,[190] and income from certain kinds of foreign trade.[191] These are narrowly defined baskets and have little impact on most U.S. corporations.

All other incomes, such as manufacturing, marketing and service profits,'[192] fall into the residual or general limitation basket. Although the additional baskets cover all types of passive income a U.S. MNC may develop, a 1992 Service report showed that nearly '75% of all foreign source income falls in the

[181] I.R.C. § 904(d)(2)(B).

[182] Hammer & Riemer, *supra* note 144, at 8. This basket was intended to prevent banks from generating foreign tax credits simply by lending in countries which impose a withholding tax. *See* David E. Spencer, *Separate Basket Rules Reduce Incentives for International Lending,* 4 J. Int'l Tax'n 89, at 91 (1993).

[183] I.R.C. § 904(d)(2)(C); Treas. Reg. § 1.9044(e).

[184] Hammer & Riemer, *surpa* note 144, at 7.

[185] I.R.C. § 904(d)(2)(E).

[186] I.R.C. § 904(d)(1)(E).

[187] Lemein & Novack, *supra* note 71, at 857.

[188] I.R.C. § 904(d)(2)(D).

[189] I.R.C. § 904(d)(1)(F).

[190] I.R.C. § 904(d)(1)(H).

[191] I.R.C. § 904(d)(1)(G).

[192] Edrey & Jeffrey, *supra* note 70, at 116, note 54.

residual basket.'[193] Hence it is quite possible that a corporation need only refer to that basket in calculating its foreign tax credit limitation.[194]

The limitation scheme applies to the deemed paid credit provisions under § 902. As such, U.S. shareholders of partnerships are permitted to credit its proportionate share of the foreign taxes paid by the partnership.[195]

In conjunction with these changes, TRA 1986 expanded the "look thru" treatment of CFC income.[196] Under § 904(d)(3), when a CFC remits earnings to its U.S. parent, the sourcing of the remittance for foreign tax credit purposes is not determined on the basis of the parent's earnings but rather is determined on the basis of the CFC's income producing activities.[197] To properly assign such remittances to the limitation baskets, the corporate taxpayer looks through or past the form in which the remittances were made, such as dividends or interest payments, and re-characterizes the remittances according to the types of income the CFC actually generates.[198] Once re-characterized, the income is then placed within the framework of the nine foreign tax credit limitations. Likewise, when the CFC generates Subpart F income the credit for foreign taxes is claimed under § 960, with the income divided to the CFC's underlying income.[199] The relevant passive income is treated separately to the extent the CFC receives income in that category.[200]

There are important exceptions in the application of the limitation baskets to partnerships.[201] Here the focus is limited to the rules that apply to partner holding at least a 10% interest, assuming that a manufacturing MNC would desire a controlling or near controlling interest in a South African

[193] John Turro, *Tax Policy: U.S. Treasury's Interim Report on International Tax Reform Offers Policy Framework*, 6 Tax Notes Int'l 378, at 379 (Feb. 15, 1993)("Interim Report").

[194] *Id.* at 538.

[195] I.R.C. 901(b)(5); Treas. Reg. §§ 1.901 1(a)(1), 1.9011(a)(3)(iii).

[196] I.R.C. § 904(d)(3).

[197] *See* Teigen, *supra* note 69 at 3256 for an illustration.

[198] This includes all Subpart F income under I.R.C. § 904(d)(3)(B).

[199] I.R.C. § 904(d)(3)(B).

[200] Treas. Reg. § 1.9045(c)(1)(i).

[201] Davis & Lainoff, *supra* note 105.

affiliate.[202] If a U.S. corporate partner owns 10% or more of a partnership, that partner looks through the partnership to determine which § 904 baskets cover its distributive share of partnership income.[203] If the high tax kick out exception applies, the 10% partner's share of passive income is separated and recharacterized if applicable as general source income. For the high withholding tax basket,[204] the partner's share of such interest maintains the basket.[205] Finally, look through treatment results where a partnership pays interest, rents or royalties to a 10% partner in a manner that would have triggered look-through treatment had a foreign corporation made the payment to a related party.[206]

2. *Summary of Foreign Tax Credit Changes*

Typically a manufacturing MNC will have most of its foreign source income fall into residual or general limitation baskets and generally speaking will have most of its active income source taxes at rates which are higher than 35%. Investments made prior to 1986 that generated certain types of passive income, taxed for the most part at rates substantially lower than the corporate tax, at least partially offset the buildup of excess credits from business operations in hightax jurisdictions.

Hence the substantial lowering of the corporate tax rate and changes in the crediting of foreign taxes have placed most U.S. manufacturing MNCs in a position of having a 'chronic excess of foreign tax credits.'[207] More precisely, U.S. MNCs will have 'excess foreign tax credits in the active income basket and excess limitation in the other separate baskets."[208] Since credit

202 For a full discussion *see* Davis & Lainoff, *supra* note 105. Also, the financial service income basket of § 904(d)(1)(C) is not applicable under these assumptions.

203 Treas. Reg. § 1.9045(h)(1).

204 I.R.C. § 904(d)(1)(B).

205 Davis & Lainoff, *supra* note 105.

206 I.R.C. § 904(d)(5)(C0; Treas. Reg. § 1.9045(h)(1); *see also* Davis & Lainoff, *supra* note 105.

207 Andrus 1992, *supra* note 138, at 1128.; Larkins, *supra* note 148, at 64; Andre P. Fogarasi et al, *U.S. Foreign Tax Policy And American Business Competitiveness in the Global Marketplace, in* U.S. FOREIGN TAX POLICY: AMERICA'S BERLIN WALL (IRET, ed. 1991), at 41.

208 Roy D. Hogg & Jack M. Mintz, "Impacts of Canadian and U.S. Tax Reform on the Financing of Canadian Subsidiaries of U.S. Parents," in Studies in International Taxation, (Alberto Giovaninni et al., ed., 1993), 4776, at 58.

limitations must be calculated for each income basket, the blending of the credits generated from lowtax jurisdictions with those generated in a hightax jurisdiction is now limited to the extent each limitation basket contains sources of income which are taxed at different rates. Thus, the amount of excess foreign tax credits for U.S. corporations went from $800 million in 1986 to $2.3 billion two years later.[209]

These changes severely restrict the ability of American MNCs to use foreign tax credits as a means of reducing their U.S. tax liability on worldwide income. As a result, U.S. manufacturing MNCs must now search for ways to "generate lowtax, general basket, foreignsource income and/or reduce the effective foreign tax rate by increasing the expenses of its foreign operations."[210] The latter option using expenses to reduce foreign source is also directed by the TRA 1986 reforms with respect to interest expense, as discussed in the next section.

C. *Interest Expense Allocations with Affiliated Groups*

Prior to TRA 1986, the 1977 Regulations allocated an affiliated group's interest expense for foreign tax credit purposes on a companybycompany basis.[211] Under those regulations, interest expense within an affiliated group was considered a 'fungible' resource that affected all incomeactivities within the group.[212] Interest expense which is not specifically linked to a set of assets or incomeproducing activities is "attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid."[213] The ratable portion is allocated to gross income generated by all of the corporation's income producing activities and properties.[214] Each entity in an affiliated group allocated interest expense between domestic and foreign source income according to either the value of the assets which generated the income in which the

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209 Michael S. Schadewald & D. Eric Hirst, *An ABC Approach to Reducing Excess Foreign Tax Credits,* 19 Int'l Tax J. 83, 83 (1993).

210 Philip L. Tretiak, *"Tax Planning for U.S. Multinationals,"* 19 Int'l Tax J. 67, 7574 (1993).

211 Patrick, *Converting Income and Expenses to Domestic or Foreign Source,* 6 Taxes 1045 (1984).

212 Treas. Reg. § 1.8618(e)(2)(i)(1977).

213 Temp. Treas. Reg. § 1.8619T(a).

214 Treas. Reg. § 1.8618(e)(2)(ii)(1977).

interest was incurred[215] or the amount of gross income generated by the assets in question.[216] Under the gross assets method, the parent corporation could allocate its interest expense on a companybycompany basis, irrespective of whether an affiliated entity actually received a loan.[217]

These rules prompted MNCs to organize the asset structures and income activities their domestic and foreign subsidiaries in ways that maximized the foreign tax credit election.[218] Substantial tax savings could be gathered simply by shifting the group's borrowing activities from overseas operations to domestic subsidiaries which produced only domestic source income.[219] Parent corporations apportioned interest expense to the domestic source incomes of their affiliated companies, thereby reducing their domestic tax liabilities.[220]

Attributing expenses this way prompted U.S. MNCs to make substantial use of inter-company lending for their overseas affiliates.[221] Since the U.S. parent deducted the interest incurred in securing the loan in the United States, the subsequent interest income from the repaying foreign affiliate resulted in a 'wash' for U.S. tax purposes. However, the interest income inflated the parent's source of foreign income, thus raising the overall activesource income basket. In short, applying the allocation regulations on a company by company basis permitted the U.S. parent to lessen the amount of expenses attributable to foreign source income.[222] Thus it is not surprising that in 1986, the reported net foreign source income of U.S. corporations exceeded $140 billion, a sum representing over 50% of their worldwide incomes.[223]

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[215] Treas. Reg. § 1.8618(e)(2)(v)(1977).

[216] Treas. Reg. § 1.8618(e)(2)(vi)(1977).

[217] *Id.*

[218] Andrus 1992, *supra* note 138, at 1009.

[219] Sellers & Thomas, *supra* note 8, at 152.

[220] GARY CLYDE HUFBAUER, U.S. TAXATION OF INTERNATIONAL INCOME, 102 (1992)(hereinafter "Hufbauer").

[221] Timothy F. Windholtz & Joseph E. Bernot, *International RelatedParty Debt: Part II,* 2 J. Int'l Tax'n 147, at 147 (1991).

[222] *Id.*

[223] Rosanne Altshuler & Scott Newton, *The Effects of U.S. Tax Policy on the Income Repatriation Patterns of U.S. Multinational Corporations,* in STUDIES IN INTERNATIONAL TAXATION, 77, at 77 (Alberto Giovannnini et al., eds., 1993).

Combined, the pre1986 foreign tax credit limitation scheme and interest expense allocation rules produced "an unwarranted increase in the amount of foreign tax credits available to an affiliated group of corporations."[224] In seeking to prevent "U.S. taxpayers from arranging their affairs to maximize the foreign tax credit at the expense of U.S. taxes on U.S. source income,"[225] Congress substantially reformed the sourcing of expenses among affiliated corporations.[226]

1. *New Interest Expense Allocation Rules*

Through the enactment of § 864(e), TRA 1986 completely reformulated the allocation of interest expense within affiliated corporate groups for foreign tax credit purposes. A new rationale called "water's edge fungibility" attributes the interest expense of all U.S. entities of an affiliated group to all income within the group. Affiliated companies are treated "as if they are one taxpayer rather than separate taxpayers."[227] Since any loan within an affiliated corporate group could have been secured by any or all of the group's assets, the interest deduction should be ratably spread across all of the group's income producing activities.[228] A key distinction is made, however, in that the interest expense of U.S. each entity within the affiliated corporate group ripples across the income of the entire group while the interest expense of each foreign subsidiary within the same group travels only as far as the edge of its own income.

As such, all U.S. entities which file or are eligible to file a U.S. consolidated return[229] now allocate interest expense on a consolidated group basis to the domestic and foreign source income of the entire group.[230] To meet these changes, "affiliated group" assumes a broader meaning for interest expense pur-

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[224] HOUSE COMMITTE REPORT, TAX REFORM ACT OF 1986, at 1396.

[225] RICHARD DOERNBERG, INTERNATIONAL TAXATION IN A NUTSHELL, 165 (2nd ed., 1993).

[226] Andrus 1992, *supra* note 138, at 11056.

[227] STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX REFORM ACT OF 1986, 513 (1986); *see* I.R.C. § 864(e)(1).

[228] I.R.C. § 864(e)(1); Temp. Treas. Reg. § 1.86111T.

[229] *See* note 5 and accompanying text, *supra*.

[230] I.R.C. §§ 864(e)(1) and (6).

poses[231] and an assetbased apportionment methodology replaces the previous separate, companybycompany approach.

Apportionment fractions organize the interest deductions by comparing the value of the incomeproducing domestic and foreign assets within the group.[232] After aggregating the interest expense of all U.S. entities within the affiliated group, the total is first re-divided by class of gross income[233] and then by all foreign and domestic sources of income within each class.[234] The taxpayer's choice now falls in the area of valuation method, in that the assets can be valued either by an adjusted tax basis or tax book value or, alternatively, at their fair market value.[235] Values for total foreign assets and total domestic assets form the basis for allocating an amount of aggregate interest expense to each class of gross income. However, the assets of a foreign branch[236] of a U.S. corporation[237] are valued by direct examination of the adjusted tax basis[238] while the foreign subsidiary's assets are valued by the shareholder's basis in the subsidiary's stock increased by undistributed earnings.[239]

For example,[240] in 1986 a parent corporation held incomeproducing domestic assets which had a value of $1000 and incomeproducing foreign assets also valued at $1000. The parent earned $200 in domesticsource income and received $100 in foreign source income from its non-controlled foreign subsidiary in a taxable year. The latter incurred $15 of interest expense while the parent incurred $60 of interest expense Only $60 of interest is allocable against the parent's consolidated income. If the allocations were based on gross income within the affiliated group ($300), twothirds of aggregate interest expense 2/3 of

[231] Temp. Treas. Reg. § 1.86111T(d)(2) requires the inclusion of Section 936 corporations in the definition of "affiliated group" set forth in § 1504(a).

[232] I.R.C. § 864(e)(2), Temp. Treas. Reg. § 1.86111T(c).

[233] Temp. Treas. Reg. § 1.8618(a)(2).

[234] I.R.C. § 864(e)(2).

[235] Treas. Reg. § 1.8619T(g)(1)(ii). Each approach uses an average of the beginning year and ending year values. Taxexempt assets are excluded in this determination under I.R.C. § 864(e)(3).

[236] Branches are viewed as integrated units of U.S. corporations and their earnings are taxed currently by the U.S. under residence jurisdiction. 1 Isenbergh, *supra* note 99, at 151.

[237] Temp. Treas. Reg. § 1.8619T(f)(2).

[238] Temp. Treas. Reg. § 1.86112T(c).

[239] This example is drawn from 1 Isenbergh, *supra* note 99, at 208.

[240] I.R.C. § 864(e)(7)(C).

$600 or $400 would be allocated to domesticsource income ($60 × $200/$300). However, under the asset method, the aggregate interest expense is split in half because the values of domestic assets and foreign assets were equal. Thus $30 would have been allocated to both foreign source income and domestic source income.

Thereafter allocated amounts are re-divided between statutory and residual groupings within foreign source and domestic source income and then among the separate foreign tax credit baskets.[241] Expenses allocated to foreign source income must then be apportioned among the relevant income baskets for foreign tax credit purposes. Here again the apportionment occurs under the assets method[242] and § 864(e) also adjusts the basis of the stock of foreign subsidiaries whenever their earnings are retained. In the example above the $300 allocated to each gross income class divides into deductions for the relevant income baskets within the class. So if the foreign source income of $1000 is comprised of $500 from the active income basket and $500 from the passive income basket, then the $300 is once more split in half and apportioned to each of these baskets as a $150 deduction.

The application of these rules increases in complexity by the number of affiliates and sources of income involved.[243] Assume a U.S. parent owns a CFC and a non-controlled § 902 corporation in the same host country, W. Assume that the CFC earns $1000 in general income while the noncontrolled § 902 corporation remits $500 in dividends (total foreign source income $1500). Income and withholding taxes paid or deemed paid in host country W total $750. If no expenses are apportioned to these income baskets, then the foreign tax credit limitation for the $1000 of general income is $350 (U.S. tax rate multiplied by the amount) while the foreign tax credit limitation for § 902 corporate dividends is $175 (35% of $500). That is, $525 of $750 in foreign taxes paid in W can be used to offset U.S. tax on the $1500 in foreign source income.

241 I.R.C. § 864(e)(2).

242 *See* Williams & Havard, *Foreign Tax Credit Rules are a Real Basket Case for US Expatriates,* 17 Tax Management Int'l J. 555 (1988).

243 Leonard, *supra* note 12, at 499.

The same result occurs if no separation of income exists (35% of $1500 = $525). However, if interest expense is apportioned among the baskets, a different sum results. Assume $300 in interest expense is allocated to the foreign source income class and that the value of the CFC's assets total $10,000 while the value of the noncontrolled § 902 corporation's assets equal $5,000. Apportioning the $300 interest expense based on these values results in having a $200 deduction in the general income from the CFC ($1000$200= $800) and a $100 deduction in the § 902 dividend income basket ($500$100= $400). The foreign tax credit limitations are adjusted down to $280 (35% of $800) and $140 (35% of $400), respectively. The apportionment of interest expense among the foreign source income baskets resulted in a loss of $105 in foreign tax credits (from $525 to $420).

Compounding the loss of $105 in foreign tax credits is the likelihood that the host country, W, will not permit a deduction for the amounts apportioned to the CFC and noncontrolled § 902 corporations. Rather, only interest expense accrued from loans secured within W are likely to be deductible. Thus, without the presence of substantial local debt obligations, greater amounts of foreign source income are subject to double taxation. Such losses may increase the effective U.S. tax rate by several percentage points.[244]

There are three circumstances in which § 864(e) departs from the assetbased allocation scheme and permits interest expense to be directly allocated to domesticsource income, foreign-source income by way of foreign tax credit limitation basket or foreignsource income.[245] The first instance, called qualified non-recourse indebtedness, involves interest on indebtedness arising from the acquisition of specific property.[246] To qualify,

[244] T. Timothy Tuerff and Keith F. Sellers, *Taking Advantage of Exceptions to Assetbased Apportionment,* 1 J. Int'l Tax'n 261, 261 (1991).

[245] Temp. Treas. Reg. § 1.86110T(a), (b).

[246] Temp. Treas. Reg. § 1. 86110T(b)(2)(i)(v). To begin with, the loan must have the purpose of either improving real property or tangible personal property or purchasing amortizable property. Loan proceeds can only be used to purchase or improve the property. The loan instrument must attach to the property and the creditor can only look to that property as security. Income generated by the property must be of an amount that would assure repayment of the loan obligations. Lastly, the loan instrument must also restrict the means of disposing of the prop-

five conditions concerning the debt and the property must be met.[247] If these conditions are satisfied, the interest expense is directly allocated to domestic source income and the values of the specific property, interest and income generated by the property are not calculated in the allocation and apportionment calculations. The theory behind this exception is that the loan and accompanying interest payments are so closely related to the 'particular property and income generated therefrom that application of the fungibility rule is not justified by economic realties.'[248]

The second exception is for integrated financial transactions, which consist of loans used to fund term financial investments. Here again several conditions attach,[249] and if met, the interest expense is directly allocated to the income generated by the investment.[250] The purpose of this exception is to "enable corporations to arbitrage financial instruments or to incur interest expense to carry portfolio investments without reducing their foreign tax credit."[251] Since neither of these narrow exceptions correspond with the focus of this Comment, the discussion shifts to the third and most controversial exceptions known as the 'CFC netting rule' which has had a significant impact on U.S. manufacturing MNCs.

2. *CFC Netting Rule*

Prior to 1986, inter-company lending provided clear tax benefits for U.S. MNCs in that such loans increased the group's foreignsource income through the payment of interest by the foreign affiliate (foreignsource interest income) while at the same time reducing U.S. source income through the interest deduction incurred on the original loan.[252] The Service considered such financing as tax motivated and sought ways to equalize

erty according to the creditor's right to look to the property as security. The expectation is measured by cash flow. 1 Isenbergh, *supra* note 99, at p.211.

[247] Joseph E. Bernot, *Allocating Interest Expense Under the Direct Allocation Provisions of the Temporary Regulations*, 16 Int'l Tax J. 89, 9192 (1990)(hereinafter "Bernot").

[248] Temp. Treas. Reg. § 1.86110T(c)(2)(i)(vi).

[249] Temp. Treas. Reg.. § 1.86110T(c)(1).

[250] Bernot, *supra* note 247, at 102.

[251] Kresge & Throndson, *supra* note 161, at 157.

[252] Andrus 1992, *supra* note 138, at 1128.

the U.S. tax treatment of inter-company lending with that of offshore third party loans.[253] However, since the allocation and apportionment of interest expense scheme under § 864(e) specifically exclude CFCs,[254] TRA 1986 could not by itself meet this goal. Instead, special interest expense allocation rules for CFCs were enacted in 1987. Known as the CFC netting rule[255] final regulations emerged, after three attempts,[256] in April 1992 that cover loans to CFCs by U.S. corporate taxpayers which own at least 10% of CFC's stock.[257]

In determining foreign source taxable income, portions of the parent's third party interest expense is now directly allocable to the interest income receives it from related CFCs. In effect, this rule monitors, through a three step process, the inter-company lending according to the parent's debt-to-assets ratio and the debt-to-assets ratios for all of its CFCs.[258] The first step involves determining 'whether the ratio of the collective CFCs' debt to the U.S. parent and the value of the affiliated group's assets have increased over a corresponding base period ratio.'[259] The total amount of a CFCs' debt deemed to be linked to an increased ratio is called "excess related group indebtedness" ("ERGI") and requires several calculations to derive.[260] The foreign base period ratio a figure usually representing the preceding five years serves as a baseline of the U.S. parent's inter-company lending activities with regard to its CFCs.[261]

The second step determines whether the ratio of the parent's third party debt to its assets increased over a U.S. base period ratio. The total amount of third party debt owed by the U.S. parent that is linked to an increased ratio in this respect is called 'excess U.S. shareholder group indebtedness' ("EUSSI"). Again, several calculations are required to derive this

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253 Sanford H. Goldberg et al., *Final Regs. on Interest Allocation Clarify the Netting Rule,* 77 J. Tax'n 176, at 176 (1992).

254 Temp. Treas. Reg. § 1.86110T(e).

255 Kresge & Throndson, *supra* note 161, at 156. *See* Paul Bodner & Thomas Bryan, *New Allocation and Apportionment Regs. Contain Contraditctory Approaches,* 75 J. Tax'n 112 (1991); Bernot, *supra* note 247.

256 Temp. Treas. Reg. 1.86110T(e)(1), (e)(2)(i).

257 Andrus 1992, *supra* note 138.

258 Lederman & Hirsh, *supra* note 98, at 71-72.

259 For a brief explanation, *see* Kresge & Throndson, *supra* note 161, at 158.

260 Lederman & Hirsh, *supra* note 98, at 71.

261 *Id.*

amount,[262] with the parent's U.S. base period ratio representing the parent's overall borrowing activity.[263]

The third and final step occurs only if an affiliated corporate group contains both excess related group indebtedness and excess U.S. shareholder group indebtedness. In that case, a calculation is made to determine the amount of the parent's interest expense that is allocated directly to the group's foreign source income. The allocable related group indebtedness of the U.S. parent, which is the lesser of ERGI or ESI, is divided by the aggregate amount of related group indebtedness. This ratio then is multiplied by the total amount of interest income received by the U.S. parent on related group indebtedness. Thereafter the allocated interest is apportioned among the separate foreign tax credit limitation baskets.

The rule is applicable only where a U.S. corporation has both excess related group debt and excess U.S. shareholder debt.[264] Also, the netting rule is not applicable when a U.S. parent, in acquiring a foreign target to a shareholder level that results in CFC status, re-computes both foreign base and U.S. base period ratios in order to treat the target as if it had been a member of the parent for the base years as well as for the entire year in which the acquisition was made.[265]

Interest expense allocation and apportionment rules for corporate foreign partnerships depend on the ownership interest involved. If the U.S. corporate partner holds a 10% interest in a foreign joint venture, interest apportionment occurs through the asset based scheme.[266] If the partner is the U.S. parent of a MNC, then the apportionment of the group's interest expense will include the parent's pro rata share of the joint venture's interest expense.[267] The pro rata asset share is valued by the tax book value without reference to the partnership's earnings.[268] Interest is then apportioned according to the affili-

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262 Lederman & Hirsh, *supra* note 98, at 72-73.

263 Temp. Treas. Reg. § 1.86110T(e)(1).

264 Temp. Treas. Reg. § 1.86110T(e)(9)(iv).

265 Temp. Treas. Reg. § 1.8619T(e)(2).

266 *Id.*

267 Temp. Treas. Reg. § 1.8619T(e)(2).

268 Temp. Treas. Reg.. § 1.86111T.

ated corporate groupings under § 864(e)(1) and the regulations.[269]

4. *Summary of Interest Expense Changes*

The modified 'fungibility' rationale and the introduction of § 864(e) have, with the exception of three narrow instances, eliminated the direct allocation of interest expense to a single class of income. Instead interest expense within the affiliated groups now attaches to foreignsource income and domestic source income regardless of how the loan proceeds were expended. The new scheme gives interest deductions which are not needed for U.S. tax purposes and which cannot be used for foreign tax purposes. Likewise in disaggregating the parent's interest deduction among its interestpaying foreign subsidiaries, the CFC netting rule monitors both the inter-company borrowing of related CFCs and the parent's domestic lending activity. In so doing, it "discourages U.S. shareholders from borrowing and re-lending funds to [CFCs] to achieve a substantially more favorable allocation and apportionment of interest expense for foreign tax credit limit purposes than would have been achieved if the foreign corporations had directly borrowed the funds."[270]

The new interest expense rules have been roundly criticized since their enactment, in part for "ignor[ing] the fact that foreign subsidiaries borrow for themselves."[271] Indeed proposed reforms center on the inclusion in the apportionment fractions of the interest expense and assets of non-U.S. entities within

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[269] *Id.*

[270] Interim Report, *supra* note 193, at 380; *see also* Wilensky, *supra* note 79, at 1006.

[271] On May 27, 1992, Chairman Dan Rostenkowski and member Willis Gradion of the Ways and Means Committee of the House of Representative introduced the Foreign Income Tax Rationalization and Simplification Bill of 1992, H.R. 5270, which would have amended the water's edge fungibility approach to interest expense allocations within affiliated groups to include the interest expense and assets of foreign subsidiaries. Paul W. Oosterhuis, *Recent and Pending Foreign Tax Legislation,* 338 P. L. I. Tax 7, at 7 (1993). It remains unlikely that this legislation or an offshoot thereof, will be 'revived' the during 1994-95 legislative sessions. John Turro, *United States,* 8 Tax Notes Int'l 97, at 97 (January 10, 1994).

the affiliated group.[272] The main planning implications arising from these changes are noted below.

E. *Impacts on Multinational Corporate Strategy*

These changes profoundly altered the longterm planning considerations of U.S. MNCs. Whereas deferral of foreign-source income was once an integral part of overseas business planning, the same strategy may now cause a greater portion of foreign tax credits to expire unused.[273] Additionally, the strategy of developing overseas investments which produced lowtaxed foreign sourceincome to soak up excess foreign tax credits has been rendered obsolete by the separate limitation baskets.[274]

The number of planning options available to U.S. parents under the new interest expense rules is limited. Shifting entire operations that produce active basket income from a hightax jurisdiction to a lowtax jurisdictions will reduce the excess credit problem[275] but appears to be an impractical option for most U.S. manufacturing MNCs. Perhaps a more realistic strategy is to increase the amount of deductions attributable to domestic source income[276] while at the same time restructuring income producing activities to avoid generating unusable foreign tax credits.[277] Since fewer credits are gained when the gross taxable incomes in the host countries are reduced by deductions, interest expense represents a valuable planning tool in that a U.S. parent may at least lower its foreign tax liabilities.[278]

Hence the importance of using debtbased acquisitions to finance international operations. Since the use of domestic thirdparty finance will result in a portion of the interest expense being allocated to the parent corporation's foreign source income, it is essential that the target finance a portion of the acquisition cost. If the foreign target secures a loan locally and then purchases assets in order to complete the U.S. parent's ac-

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[272] Foreign tax credits can be carried back three years or forward two years under § 904(c).

[273] Lemein & Novack, *supra* note 71, at 845.

[274] Larkins, *supra* note 148, at 645.

[275] Doernberg, *supra* note 225, at 86.

[276] Friedman, *supra* note 112, at 23.

[277] Andrus 1992, *supra* note 143 at 10181020.

[278] Wilensky, *supra* note 79, at 1006.

quisition, the affiliate charges interest on the loan against its local taxable income. The same interest expense reduces the amount of gross foreign source income *prior to repatriation,* thus lowering the amount of foreign tax credits generated.[279] These loans also reduce the subsidiary's unremitted earnings which would otherwise increase the value of the parent's foreign assets for apportionment purposes.[280]

A far different result occurs when the subsidiary's working capital requirements are funded by inter-company loans. Because loans to foreign subsidiaries increase the value of the parent's foreign assets, their continued use will gradually increase the amount of interest expense allocable to foreign source income by virtue of increasing incomeproducing foreign assets.[281] The parent is deemed to have made a loan at an arm's length interest rate[282] and a portion of that interest expense will be allocated to foreign source income where the local affiliate will not be able to use it as deduction.[283] If the foreign subsidiary is not a CFC and the U.S. parent holds excess foreign tax credits, then the interest income received from the subsidiary is deemed to be passive basket income, thus fully taxable to the U.S. parent.[284]

If instead the non-controlled subsidiary retains the earnings and profits, a greater portion of the U.S. parent's interest expense will be apportioned to foreign source income due to the increased value of the foreign assets, lowering the foreign tax credit limitation.[285] The amount of foreign tax credits generated is lower because the income remitted to the parent has been reduced by the interest deductions in the host country. Since the tax basis of a noncontrolled subsidiary is increased by undistributed earnings and profits, the interest payments also reduce the amount of earnings and profits that may remain with the affiliate.

Likewise, the CFC netting rule not only increases the amount of taxable passive basket income that remains unpro-

[279] Andrus et al., *supra* note 126, at 687.
[280] Friedman, *supra* note 112, at 25.
[281] Treas. Reg. § 1.4822(a)(1) and (2) (1986).
[282] Leonard, *supra* note 12, at 497.
[283] Friedman, *supra* note 112, at 25.
[284] *Id.*
[285] Andrus 1992 *supra* note 143, at 1128.

tected by foreign tax credits but, more fundamentally, allocates greater amounts of interest expense to foreign source income.[286] In that respect, its effect mirrors that of the assetbased allocation scheme of § 864(e). If the CFC earns passive basket income, it must allocate interest expense on its inter-company debt against passive basket income in an amount equal to its passive basket income.[287] This means that the interest income received by a U.S. parent will be passive to the extent that the CFC earns passive basket income. The amount of interest expense paid by the CFC to the parent that exceeds the CFC's passive income account is then placed into the general limitation basket, which is likely to have excess credits to begin with.

Given these planning considerations, the financing structure of overseas affiliates demand constant monitoring in order to maintain acceptable tax costs. The following section compares these provisions with relevant interest expense provisions British, German and Japanese MNCs encounter in their respective tax systems.

F. *Comparisons with Britain, Germany and Japan*

Four countries the United States, Great Britain, Germany and Japan form the world's leading capital exporters[288] and competition among them for emerging markets in developing economies has in recent years led to a greater emphasis on non-traditional forms of foreign business arrangements,[289] especially 'joint ventures, licensing, franchising and turnkey projects.'[290] Indeed, the tremendous spate of international mergers and acquisitions during the 1980s evinces the significance strategic investment planning has within multinational corporations.[291]

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286 Treas. Reg. 1.9045(c)(2)(ii)(C).

287 ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, INTERNATIONAL DIRECT INVESTMENT AND THE NEW ECONOMIC ENVIRONMENT (1989).

288 *See generally* CHARLES OMAN, NEW FORMS OF INTERNATIONAL INVESTMENT IN DEVELOPING COUNTRIES, (1984).

289 TIMO VIHERKENTTÄ, TAX INCENTIVES IN DEVELOPING COUNTRIES AND INTERNATIONAL TAXATION, 11 (1991). For concise definitions of these terms, *see* Daniels, *supra* note 6, at 563.

290 Weston et al., *supra* note 103, at 42039.

291 Income and Corporation Taxes Act ("ICTA") 1988, § 8.

Given these impacts, the following section briefly looks at how interest expense among resident multinationals is handled in Great Britain, Germany and Japan. All of the points herein, except for a few, were drawn from secondary sources and are provided merely to indicate the complexity of the TRA 1986 reforms relative to the main interest expense provisions in these countries.

1. *Great Britain*

Resident corporations are taxed on their worldwide income,[292] with residency status being determined by place of incorporation.[293] Such corporations are required to declare income from their foreign subsidiaries only when the dividends or interest income have been repatriated.[294] Interest expense is a permitted deduction which can be set against gross income.[295] The entire interest expense is deductible, regardless of how the expense is allocated.[296] This rule includes indebtedness incurred in acquiring a foreign corporation.[297] The MNC's interest expense is not allocated to foreign source income.[298]

The foreign affiliates of British corporations generally may not deduct interest unless it is either from a bank operating in the United Kingdom or it is a charge on income.[299] In terms of the latter, "the interest must be paid out of the company's profits‹ and made under a liability incurred for a valuable and sufficient consideration."[300] These conditions appear to be easily met under most circumstances. Additionally, most British double taxation treaties exempt parent corporations from tax on interest payments made by foreign subsidiaries.[301] These trea-

[292] Viherkenttä, *supra* note 24, at 47.

[293] J.A. KAY & M.A. KING, THE BRITISH TAX SYSTEM, 179 (4th ed., 1986) (hereinafter "Kay & King").

[294] I.C.T.A 1970, 233(2)(d)(iv).

[295] Viherkenttä, *supra* note 24, at 91.

[296] Eric Tomsett, *Tax Consequences of international acquisitions and business combinations: United Kingdom,* 77b C.D. Fisc. Int'l 581, 592-93 (hereinafter "Tomsett").

[297] PRICE WATERHOUSE, U.S. INTERNATIONAL TAX POLICY FOR A GLOBAL ECONOMY, 19 (1991)(hereinafter "Price Waterhouse 1991").

[298] Elliott, *infra* note 305, at 222.

[299] *Id.*

[300] *Id.* at 218-19.

[301] DAVID R. DAVIES, PRINCIPLES OF INTERNATIONAL DOUBLE TAXATION RELIEF, 155 (1985).

ties usually set ceilings on the amount of withholding tax imposed by the contracting country on related party interest payments.[302]

Because of these rules, the British tax system is thought to favor the use of debt financing as opposed to equity financing in both domestic and international acquisitions.[303] As the tax cost of unrelated borrowing is often less than the yield on investment, "the rate of return on shareholders' funds is increased by this use of external finance."[304] Although special rules for CFCs regarding foreign income and foreign tax credits exist, the Inland Revenue Commission has yet to enact an equivalent to the CFC netting rule.[305]

While the handling of interest expense in the British tax system is perhaps as equally complex as it is in the United States,[306] the flexibility of its regulations pertaining to interest and the wide coverage in British tax treaties indicate that interest expense is an area where British MNCs enjoy a distinct advantage over their American counterparts.

2. *Germany*

The Federal Republic of Germany taxes[307] the worldwide income of its resident corporations,[308] with residency determined by the place of management test.[309] Under 'a complex exemption/credit system concerning the treatment of dividends received from foreign corporations'[310] dividends received by resident parent corporations from their foreign subsidiaries gener-

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302 Kay & King, *supra* note 293, at 165.

303 *Id.*

304 *See generally* BRIAN J. ARNOLD, THE TAXATION OF CONTROLLED FOREIGN CORPORATIONS: AN INTERNATIONAL COMPARISON, 311-346 (1986)(hereinafter "Arnold").

305 Peter Elliott, *United Kingdom, in* DIFFERENCES IN TAX TREATMENT OF FOREIGN INVESTORS: DOMESTIC SUBSIDIARIES AND DOMESTIC BRANCHES, 222 (J. Forry, ed., 1984)(hereinafter "Elliott").

306 For a general survey of German taxation, *see* H.J. AULT & A.J. RÄDLER, THE GERMAN CORPORATION TAX LAW WITH 1980 AMENDMENTS (2d ed., 1981).

307 Körperschaftssteuergesetz (Corporation Tax Law hereinafter "KStG") § 1 (2) (1984).

308 Abgabenordnung (Fiscal Code) § 10 (1983).

309 Arnold, *supra* note 24, at 229.

310 Viherkenttä, *supra* note 24, at 46.

ally escape German taxation[311] if the German parent holds a 25% stake in the subsidiary.[312] Also, a tax sparing provision under the Körperschaftsteuerreformgesetz ("KStG") exempts German foreign subsidiaries operating in developing countries from German tax on repatriating dividends.[313]

For most corporate income tax purposes, interest expense is deductible, with no minimum equity required to determine deductibility.[314] A resident corporation can deduct the interest it pays on loans secured in Germany and which proceeds were sent abroad.[315] Interest deductions arising from an inter-company loan in which the parent does not own 10% equity capital in the debtor company will trigger passive income rules.[316] Such interest income is deemed to be passive income[317] unless the corporation demonstrates that "funds are borrowed exclusively on foreign capital markets and loaned on a longterm basis to businesses or permanent establishments located outside Germany whose gross revenue is derived exclusively or almost exclusively from active businesses as described above."[318] Additionally, inter-company loans must be at an arm's length interest rate.[319]

In short, German interest expense rules, while quite complex,[320] appear to provide more flexibility in the treatment of

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311 Friedrich Landwehrmann, *Legislative Development of International Corporate Taxation in Germany: Lessons for and from the United States,* 15 Harv. Int'l L. J., 238, at 244 (1974).

312 KStG § 26(3), 1984 Bundesgesetzblatt. Eligible countries are listed in EntwicklungsländerSteuergesetz (the Developing Countries Tax Act).

313 DELOITTE, TOUCHE INTERNATIONAL, TAXATION IN EUROPE, 127 (1990).

314 Price Waterhouse, *supra* note 297, at 20.

315 Deloitte, Touche International , *supra* note 313, at 127.

316 Aussensteuergesetz ("AStG"), § 8(1)(7).

317 Arnold, *supra* note 24, at 253.

318 D. Kevin Dolan, *International Strategies for Corporate Acquisitions, Dispositions, Financing, Joint Ventures, Reorganizations, and Restructurings,* 333 PLI/ Tax 341, *available in* WESTLAW, TXTP Library.

319 For a discussion of interest expense regulations in international acquisitions, *see* Wilhelm Haarmann, *Steuerliche Folgen des grenzüberschreitenden Erwerbs oder Zusammenschlusses von Unternehmen,* 77b C.D. Fisc. Int'l 297 (hereinafter "Haarmann").

320 For a general survey of Japanese taxation, *see* Y. GOMI, GUIDE TO JAPANESE TAXES 198990 (1989); *see also* H. ISHI, THE JAPANESE TAX SYSTEM (1989).

interest deductions within large corporate groups than U.S. tax law.

3. *Japan*

Under the Japanese tax system,[321] resident corporations are taxed on their worldwide income,[322] with corporate residency determined by the location of the principal office.[323] Tax credit provisions enable resident corporations to eliminate or reduce the incidence of double taxation.[324]

Interest expense incurred as "necessary expenses" are fully deductible[325] and allocable among related corporations on the basis of assets.[326] Hence the Japanese employ a rule similar to § 864(e). For acquisition indebtedness, the tax treatment divides according to the purchase shares of a foreign corporation, which is not deductible, and cash purchases of assets, which is fully deductible.[327] Since all interest income received by resident corporations is taxable, taxes paid with respect to such income are fully creditable and are not subject to percountry or baskets limitations.[328]

Overall, the Japanese interest expense rules appear, under the guise of employing malleable concepts like "necessary expenses," to afford sufficient flexibility to enable resident MNCs to avoid significant tax penalties in financing overseas acquisitions.[329] If that is case, then once again the U.S. interest expense rules place U.S. multinationals at a competitive disadvantage.

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321 Corporation Tax Law , articles 4(1) and 5 (hereinafter "CTL"). *See* Arnold, *supra* note 24, at 267.

322 CTL, art. 2(3).

323 For an interesting comparative inquiry, *see* Joel Slemrod, *Competitive Advantage and the Optimal Tax Treatment of the ForeignSource Income of Multinationals: The Case of the U.S. and Japan,* 9 Am. J. Tax Pol'y 113, 127130 (no. 1, 1991)(hereinafter "Slemrod").

324 DELOITTE, HASKINS, & SELLS, TAXATION IN JAPAN, 31 (1981).

325 *Id.* at 132.

326 Yuko Miyazaki, *Tax Consequences of international acquisitions and business combinations: Japan,* 77B C. D. Fisc. Int'l 361, 379 (hereinafter "Miyazaki").

327 *Id.* at 50.

328 Slemrod, *supra* note 323, at 130.

329 Hammer & Riemer, *supra* note 144, at 5.

G. *Summary of Part II*

The lowering of the corporate tax rate began a process wherein most U.S. manufacturing MNCs now hold excess foreign tax credits each year. This position is chronic in that the additional foreign tax credit limitation baskets virtually eliminate the parent's ability to generate 'lowtaxed foreign source income of one type that can be combined with hightaxed foreign source income of another type.'[330] Compounding these restrictions are a set of the new interest expense allocation rules which reduce the amount of foreign tax credits needed to cover the amount of gross foreign source income.[331]

As a result, most U.S. manufacturing MNCs need to minimize the amount of taxes their foreign affiliates pay.[332] Placing debt on foreign affiliates is one way to do so, although the interest expense allocation schemes of TRA 1986 certainly complicate this task. Corporate financial managers must closely evaluate the U.S. parent's foreign tax credit position and the degree of leverage of and its ownership interest in all of its foreign businesses before organizing any debtbased acquisition.[333]

With respect to debtbased transactions, it appears U.S. MNCs incur higher tax costs in acquiring or expanding overseas businesses than their British, German and Japanese competitors. The wide array of tax treaties in the British system and relatively flexible interest expense rules permit British MNCs to either wholly avoid or substantially lessen the incidence of double taxation. Even the equally complex German credit and exemption system appears to afford a wider range of planning alternatives for German MNCs than what most U.S. MNCs can carve out of the confines of TRA 1986 and subsequent regulations. Although Japan implements a similar interest expense scheme, there is more flexibility in international acquisitions than what is provided by the I.R.C.

If these propositions ring true, then the interest expense scheme arising from TRA 1986 renders U.S. MNCs less competitive in international markets *irrespective* of where specific investments are made. The question posed here is whether the

330 Andrus et al., *supra* note 126, at 685.
331 *Id.*
332 Friedman, *supra* note 112, at 47.
333 Davies, *supra* note 301, at 26.

unique conditions of a particular investment climate the current corporate return to South Africa turns this disadvantage into an incident where American MNCs are doubly burdened.

PART III. U.S. CORPORATE RETURN TO SOUTH AFRICA: NEW DYNAMICS

As noted earlier, most investment decisions for MNCs flow from an articulated business strategy. Selecting the type of financing structure that best serves the working capital needs of a particular overseas operation requires a look at the relative compatibility between U.S. tax law and the investment and tax regulations of the host country.[334]

Part III places these considerations in view of the corporate return to South Africa. The first section reviews the types of sanctions these four countries enacted during the 1980s while the second discusses the divestiture patterns that formed in response to these measures. Due to the severity of U.S. sanctions and the scope of the American corporate withdrawal from South Africa, most U.S. manufacturing MNCs interested in returning there face market disadvantages. It is argued here that these disadvantages are magnified by the basic incompatibility between South Africa investment regulations and the new U.S. interest expense rules.

A. *Overview*

Historically South Africa has relied heavily on Great Britain, the Netherlands, Germany and the United States for in-

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[334] Inflows of foreign investment in mining industries in the last two decades of the 19th century formed the foundation for many of the political & economic relationships that developed between South Africa and Western countries. Significant nonmining investments began in the 1930s and continued through the 1960s. ALLISON COOPER & MICHELINE TUSENIUS, INTERNATIONAL INVESTMENT IN SOUTH AFRICA, at 910 (1987) (hereinafter "Cooper & Tusenius"); C. M. Rogerson, *Multinational Corporations in Southern Africa,* in THE GEOGRAPHY OF MULTINATIONAL CORPORATIONS, 197220 (M. Taylor & N. Thrift, eds., 1982); and G. A. Muller, *Multinational Companies in South Africa,* SOUTH AFRICA IN THE WORLD ECONOMY, 20735 (J. Matthews, ed., 1983). For radical perspectives on foreign investment in the region, *see generally* ANN SEIDMAN & NEVA SEIDMAN MAKGETKA, OUTPOSTS OF MONOPOLY CAPITALISM: SOUTHERN AFRICA IN THE CHANGING GLOBAL ECONOMY, (1980); RUTH FIRST, JONATHAN STEELE & CHRISTABEL GURNEY, THE SOUTH AFRICAN CONNECTION: WESTERN INVESTMENT IN APARTHEID, (1974).

flows of foreign investment and trade.[335] As South Africa's manufacturing base developed rapidly after the Second World War,[336] many U.S. MNCs assumed preeminent roles in various industries, including hightech electronics[337] and military equipment.[338] By 1970, South Africa's trade relationships had diversified, due in part to a tremendous spate of investment from the world's largest MNCs[339] and an everwidening network of bilateral tax treaties.[340] The United States became South Africa's top trading partner in 1979,[341] more than thirty years after the U.S. entered a double taxation treaty with South Africa.[342]By

[335] For a historical look at American investments in South Africa, *see* RICHARD W. HULL, AMERICAN ENTERPRISE IN SOUTH AFRICA: HISTORICAL DIMENSIONS OF ENGAGEMENT AND DISENGAGEMENT, (1990); VIC RAZIS, THE AMERICAN CONNECTION, (1986); DESAIX MYERS, U.S. BUSINESS IN SOUTH AFRICA: THE ECONOMIC, POLITICAL AND MORAL ISSUES, (1980); ANN SEIDMAN AND NEVA SEIDMAN, SOUTH AFRICA AND U.S. MULTINATIONALS, (1977); DONALD MCHENRY, UNITED STATES FIRMS IN SOUTH AFRICA, (1975).

[336] *See* M. SISULU, TRANSNATIONAL CORPORATIONS INVOLVEMENT IN SOUTH AFRICA'S ELECTRONICS INDUSTRY, (1985); RICHARD LEONARD, COMPUTERS IN SOUTH AFRICA: A SURVEY OF U.S. COMPANIES, (1978).

[337] *See* ALLAN METTEN & PAUL GOODISON, FIGHTING FOR APARTHEID: A JOB FOR LIFE (1988).

[338] In fact the growth rate of South African economy was among the highest in the world during the 1960s. *Africa South of the Sahara, supra* note 24, at 806.

[339] Income and double taxation treaties include: FRANCE REPUBLIC OF SOUTH AFRICA DOUBLE TAXATION OF INCOME FROM THE OPERATION OF SHIPS AND AIRCRAFT, IN NOTES SIGNED OCTOBER 5 AND NOVEMBER 22, 1954; SWEDEN UNION OF SOUTH AFRICA INCOME TAX TREATY, SIGNED JULY 28, 1955; CANADA SOUTH AFRICA INCOME TAX AGREEMENT, SIGNED SEPTEMBER 28, 1956; UNITED KINGDOM SOUTH AFRICA INCOME TAX TREATY, SIGNED MAY 28, 1962; NETHERLANDS SOUTH AFRICA INCOME TAX TREATY AND PROTOCOL SIGNED MARCH 15, 1971; FEDERAL REPUBLIC OF GERMANY REPUBLIC OF SOUTH AFRICA INCOME TAX AGREEMENT AND EXCHANGE OF NOTES, SIGNED JANUARY 25, 1973.

[340] JAMES BARBER & JOHN BARRATT, SOUTH AFRICAN FOREIGN POLICY 275 (1990)(hereinafter "Barber & Barrat").

[341] A double taxation treaty was established in July 1946. CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNION OF SOUTH AFRICA FOR THE AVOIDANCE OF DOUBLE TAXATION AND FOR ESTABLISHING RULES OF RECIPROCAL ADMINISTRATIVE ASSISTANCE WITH RESPECT TO TAXES ON INCOME, signed Dec 13, 1946 effective July 1, 1946

[342] South Africa's strategic value to the West increased after Marxist governments assumed power in neighboring Mozambique and in Angola during 1970s. Thereafter, the possibility of direct Soviet military intervention in either of these

then two decades of Cold War politics in southern Africa[343] had inextricably linked the economic significance of American private investments in South Africa to U.S. foreign policy concerns regarding access to the country's strategic minerals and the security of the 'oil route' around Cape of Good Hope.[344]

However, South Africa's economic significance to the United States should not be overstated. Thus in 1981 when U.S. foreign direct investment in South Africa peaked at $2.6 billion in 1981,[345] that sum represented less than 2% of worldwide U.S. foreign direct investment.[346] Excluding mining investments, South African markets generally accounted for only a small fraction of the worldwide income for most American MNCs operating there. For example, even at the height of its presanctions business, the South African subsidiaries of Goodyear[347] and IBM[348] contributed less than a one percent of the parent's worldwide earnings or sales, respectively.

Significant change in the foreign relations between South African and Western countries occurred with the rise of anti-apartheid causes in Europe and North America in the 1970s, with these local and national groups crystallizing into a truly

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countries presumably posed a threat to the passage of oil shipments around the Cape of Good Hope. However, the Soviets never established a military base in Mozambique, nor did the Soviets follow the lead of its Cuban allies in sending military troops into Angola. *See* ROBERT LEGVOLD, *The Soviet Threat to Southern Africa,* in SOUTH AFRICA & ITS NEIGHBORS (R. Rotberg, ed., 1985).

343 *See* Barber & Barrat, *supra* note 340, at 45-62, 151-172, 225-244.

344 Robin Bulman, *ANC Seeks to Open S. Africa to Competition, Investment,* J. Com. & Com., Oct. 1, 1993, at 3A. However, Seidman claims that 'total U.S. financial involvement in South African including direct investment, bank loans and stockholdings, reached $14.6 billion' by 1983. ANN SEIDMAN, THE ROOTS OF CRISIS IN SOUTHERN AFRICA, 41 (1985).

345 STEPHEN LEWIS, THE ECONOMICS OF APARTHEID, 73 (1990). In 1974, British investments in South Africa constituted 1.2% of Britain's total world investment whereas the percentages for the U.S. and West Germany were 1.2 and 0.9, respectively. THOMAS CALLAGHY, SOUTH AFRICA IN SOUTHERN AFRICA, 111 (1982), *citing* J.E. SPENCE, SOUTH AFRICA, THE WORLD POWERS AND SOUTHERN AFRICA (1980).

346 Flex Kessler, *Goodyear Toughs It Out,* Fortune, Sept. 30, 1985, at 24 (hereinafter "Kessler").

347 Rosalind Rachid, *Pullouts to hit S.Africa hard psychologically,* J. Com., Oct. 22, 1986, at 1A.

348 *See generally Seizing the Moment: the Free South Africa Movement,* Wash. Rpt. on Afr., 1 Winter/Spring 1985.

international movement within a decade.[349] By 1984 South Africa had become a salient foreign policy issue in most Western countries, as the 'apartheid problem' was no longer a question of whether sanctions should be imposed but rather an issue of when and how those measures would be taken.[350]

Thus the "politicization of business" in South Africa led in part to the imposition of a wide range of bilateral and multilateral economic sanctions against South Africa between 1984 and 1988.[351] While the history of sanctions need not be retraced here,[352] the following section highlights the main features of the sanctions Britain, Germany, Japan and the U.S. imposed on South Africa during the 1980s and notes the general pattern of corporate responses to the antiapartheid movement.

B. *Economic Sanctions Against South Africa*

The history of economic and other sanctions against South Africa exhibits a mix of coercion and accommodation.[353] Although Western countries began registering official protests against apartheid in the United Nations ("U.N.") in the 1950s,[354] the first series of U.N. Security Council sanctions

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349 To some observers, only a substantial economic presence in the South Africa economy empowered U.S. foreign policy with the type of leverage that was needed to guide South Africa into an era of orderly, peaceful social change. Opposing arguments emphasized how U.S. economic ties perpetuated apartheid and that only the withdrawal of investments would force meaningful political reform there. For a diverse sampling of contemporary commentary on the issue, *see* SOUTH AFRICA: APARTHEID AND DIVESTITURE (S. Anzovin, ed., 1987).

350 *See generally* KRIS W. KOBACH, POLITICAL CAPITAL: THE MOTIVES, TACTICS & GOALS OF POLITICIZED BUSINESSES IN SOUTH AFRICA (1990).

351 *See generally* Nathan E. Fagre & Catherine Casey, *Use of Economic sanctions to promote Human Rights: the Case of Economic Sanctions Against South Africa,* C399 ALI/ABA 165, 195 (1989); MERLE LIPTON, SANCTIONS AND SOUTH AFRICA: THE DYNAMICS OF ECONOMIC ISOLATION, (1988); JOSEPH HANLON & ROGER OMOND, THE SANCTIONS HANDBOOK (1987); INTERNATIONAL ECONOMICS SEMINAR, SOUTH AFRICA: MYTHS AND REALITIES OF DIVESTITURE (1985).

352 *See generally* R. MOORSOM, SANCTIONS AGAINST SOUTH AFRICA, (1986); D.G. CLARKE, ECONOMIC SANCTIONS ON SOUTH AFRICA, (1981).

353 *See* EVAN LUARD, 2 A HISTORY OF THE UNITED NATIONS, 110-119 (1989); *see also* SANCTIONS AGAINST SOUTH AFRICA (R. Segal ed., 1964).

354 The issue of sanctions intensified after the Sharpeville Massarce in March 1960 where South African police fired on protestors peacefully demonstrating against pass laws. For a discussion of the events leading up to, during and after the shootings at Sharpeville, *see* AMBROSE REEVES, SHOOTING AT

were not enacted until the 1960s.[355] Bilateral measures followed thereafter, with the U.S. blocking International Monetary Fund (I.M.F.) lending to South Africa[356] and Japan banning all new direct investments in 1968.[357] A second wave of bilateral[358] and multilateral[359] sanctions were enacted after the 1976 Soweto riots.[360]

Antiapartheid movements in Europe and North America emerged apposite diplomatic channels, organizing consumer boycotts and publicity campaigns to force the withdrawal of foreign corporations operating in South Africa.[361] In the United States,[362] antiapartheid campaigns prompted some corporations to 'camouflage' their South African business ties[363] and led to the 1977 drafting of the Sullivan principles[364] which estab-

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SHARPEVILLE: THE AGONY OF SOUTH AFRICA (1960). A voluntary arms export embargo was adopted in 1963. U.N. SCOR 181, 18 U.N. SCOR Res. and Decs. at 7, U.N. Doc. S/INF/18/Rev. (1963); *see generally* AMELIA C. LEISS, APARTHEID AND U.N. COLLECTIVE MEASURES: AN ANALYSIS, (1965). The embargo was extended in 1970 under Resolution 282. Margaret Doxey, *International Sanctions: A Framework for Analysis with Special Reference to the U.N. and South Africa*, 26 Int'l Org. 527 (1972).

355 Doxey, *supra* note 354, at 530.

356 INTERNATIONAL LABOUR OFFICE, FINANCIAL SANCTIONS AGAINST SOUTH AFRICA, 52 (1991)(hereinafter "Financial Sanctions Against South Africa").

357 Great Britain ended North Sea oil exports to South Africa in 1977. Cooper & Tusenius, *supra* note 334, at 17; Lipton, *supra* note 351, at 16.

358 U.N. SCOR 418, 32 U.N. Scor Res. and Decs. at 5, U.N. Doc. S/INF/33 (1977).

359 Riots in SOWETO, a black township near Johannesburg, began in June and continued through December of 1976. In 1977, the U.N. Security Council elevated the arms embargo to mandatory status.

360 John Nielsen, *Time to quit South Africa?* Fortune, Sept. 30, 1985, at 1823.

361 *See generally* JANICE LOVE, THE U.S. ANTIAPARTHEID MOVEMENT: LOCAL ACTIVISM IN GLOBAL POLITICS (1985).

362 To lower their profile in South Africa, some corporations renamed their products and funnelled their transactions through thirdcountry affiliates. *See generally* ELIZABETH SCHMIDT, DECODING CORPORATE CAMOUFLAGE: U.S. BUSINESS SUPPORT FOR APARTHEID (1980).

363 Called the Sullivan Principles after its chief architect, Rev. Leon Sullivan, these fair employment principles set forth a voluntary code of conduct for U.S. corporations operating in South Africa. *See* Church Project on U.S. Investments in South Africa (1977). Thereafter U.S. corporations operating there were annually evaluated by the Arthur D. Little Co. Kessler, *supra,* at 24; *see also* Stratford Sherman, *Scoring Corporate Conduct in South Africa,* Fortune July 9, 1984, at 168-172.

364 The hiring, training and promotion practices of American corporations in South Africa came under greater scrutiny in the 1970s. *See* DESAIX MYERS,

lished fair employment standards and ethical guidelines for U.S. corporations operating in South Africa.[365] The movement squarely confronted President Ronald Reagan's foreign policy of 'constructive engagement,'[366] which led the U.S. in the early 1980s to veto U.N. resolutions that would have imposed sanctions against South Africa.[367] However, calls for international economic sanctions and corporate divestment gained greater amplitude in early 1984 after violence in South Africa's black townships led to a state of emergency and bans on press coverage.[368] Although the United Nations never enacted mandatory measures during this period,[369] over seventy countries imposed bilateral economic sanctions on South Africa during this time.[370]

1. *Sanctions Compared*

In the United States, the question of South African sanctions reached all levels of government[371] as eventually '27 states, 88 cities and 24 counties enacted laws or policies' which penalized U.S. corporations for conducting business in South

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LABOR PRACTICES OF U.S. CORPORATIONS IN SOUTH AFRICA (1977). The European Community set forth a similar ethical review. *See* James Barber, *The EEC Code of Conduct for South Africa: Capitalism as a Foreign Policy Instrument,* World Today, March 1980.

365 U.S. foreign policy emphasized a process of gradually increasing political and economic pressure on the South African government to accept a moderate pace of political reforms. For a concise discussion on the policy and its origins, *see* Chester Crocker, *South Africa: Strategy for Change,* 59 Foreign Affairs, 323 (Winter 1980-1981). Crocker was the Assistant Secretary of State of African Affairs under the Reagan administration and chief architect of the policy. For a fuller discussion, *see* CHRISTOPHER COKER, THE UNITED STATES AND SOUTH AFRICA, 1968-1985: CONSTRUCTIVE ENGAGEMENT AND ITS CRITIC (1986).

366 *See* Seidman, *supra* note 335, at 94-95.

367 *See* Barber & Barratt, *supra* note 340, at 303-308.

368 In February 1987, the U.S., West Germany and Britain vetoed a United Nation Security Council Resolution which called for the implementation of mandatory economic sanctions against South Africa even though the resolution was modelled after the sanctions that were passed by the U.S. Congress less than five months earlier. Afr. Econ. Dig., Feb. 28, 1987, at 17.

369 Afr. Bus., Nov. 1989, at 13.

370 For a discussion of the types of sanctions enacted, *see* Lyn Berat, *Undoing and redoing business in South Africa: the lifting of the Comprehensive AntApartheid Act of 1986 and the continuing validity of state and local antiapartheid legislation,* 6 Conn. J. Int'l L. 7, at 14-22 (1990).

371 Richard Lawrence, *S. African Trade Seen Edging Up As U.S. Lifts Ban,* J. Com. & Com., July 11, 1991, at 1A.

Africa.[372] Most state and local legislation followed the September 1986 enactment of the Comprehensive AntiApartheid Act ("Comprehensive Act").[373] In overriding a presidential veto,[374] Congress imposed total bans on imports of South African uranium, coal and textiles and on a wide range of exports, including computers, petroleum products, and nuclear technology.[375] Public and private financial and investment restrictions also were imposed,[376] the Foreign Sales Corporation (FSC) certification was revoked[377] and the U.S.-South Africa double taxation treaty was terminated.[378] Repeal of the Comprehensive Act was conditioned on a list of political reforms and events, including the release of imprisoned ANC leader Nelson Mandela.[379]

A year later, Congress eliminated the foreign tax credit election for income taxes, war profits, or excess profits paid in South Africa.[380] This measure, known as the Rangel Amend-

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372 22 U.S.C § 5001, Pub. L. No. 99440 (October 2, 1986).

373 Reagan vetoed the Comprehensive AntiApartheid Bill of 1986 (H.R. 4868) claiming that the bill would 'seriously impede the prospects for a peaceful end to apartheid.' However, in one of the few instances in which Congress overrode a presidential veto during the Reagan administration, the House and Senate voted 313 to 83 and 84 to 14, respectively, to override the veto on September 29, 1986. CCH Tax Day: Federal Sept. 30, 1986, F86273002. For a discussion of the forces behind the 1986 sanctions legislations, *see* Winston Nagan, *Economic Sanctions, U.S. Foreign Policy, International Lawand the AntiApartheid Act of 1986*, 4 Fla. J. Int'l L. 85 (1988).

374 Afr. Econ. Dig. Oct. 11, 1986, at 54.

375 An exception was made for investments in companies wholly owned by black South Africans. *See* Louis K. Rothberg, *Sections 402 and 403 of the Comprehensive AntiApartheid Act of 1986*, 22 Geo. Wash. J. Int'l L. & Econ. 117 (1989).

376 As of July 1, 1987, loss of FSC status meant U.S. corporations could no longer benefit from the protection I.R.C. §§ 922 and 924 offer for U.S. exports.

377 The South AfricaUnited States Income Tax Convention, operative since 1946, was terminated on October 31, 1986 but due to a provision contained in the treaty the termination did not become effective until six months after the abrogation. Hence on July 1, 1987 the treaty officially terminated. *Income Tax treaty Between U.S. and South Africa to Terminate*, CCH Tax Day Nov. 3, 1986, *available in* LEXIS, FEDTAX Library.

378 Section 311(a) of the Comprehensive Act sets out the provisions and notification requirement in addition to the five political reforms, which were 1) the release of all political prisoners; 2) repeal of the state of emergency; 3) ending the ban on opposition political parties; 4) repeal specific laws; 5) enter good faith negotiations with representatives of the black majority.

379 Congress enacted § 901(j)(2)(C)(i) to the I.R.C. subchapter N by amending by § 10231 of the Revenue Act of 1987 (Pub. L No. 100203, 101 Stat. 1330382) on 12/22/87.

380 The amendment derives its names from New York Congressman Charles Rangel who introduced it. The amendment's legislative history is interesting as it

ment,[381] also required that the earnings of CFCs operating in South Africa to be subject to subpart F treatment.[382] Repeal of these measures, which went in effect on January 1, 1988,[383] was also linked to the guidelines set by Comprehensive Act.[384]

The termination of the double taxation treaty, the loss of the foreign tax credit mechanism and the general inability to export certain technologies wholly undermined the profitability of most American operations in South Africa. In 1987 alone, the loss of foreign tax credits totalled $56 million.[385] Although South Africa taxes were still deductible, the change exposed all income producing investments to the full brunt of double taxation. Ironically, the federal measures made it impossible for most U.S. MNCs to comply with sanctions imposed by other countries and avoid the antiboycott provisions within the I.R.C.[386]

The scale and punitive scope of these measures dwarf the bilateral sanctions by Britain, Germany and Japan implemented during the same period. In Britain, Prime Minister Margaret Thatcher steadfastly refused, against considerable public and international pressure, to impose mandatory bilateral economic sanctions on South Africa.[387] However, after the

was apparently a 'last minute' addon to a finance bill that was "adopted without debate and reportedly without most Congressmen knowing about it." Barber & Barratt, *supra* note 340, at 336.

381 I.R.C. § 901(i), as amended Section 10231 of the Revenue Act of 1987, effectively subjects current income to be included in gross income. I.R.C. § 952(a)(5). *See* Rev. Rul. 9053, 90 FED par. 46, 349. *See also Tax Effects of the Repeal of Sanctions Against South Africa,* Tax Adviser, Nov. 1991, at 736.

382 In Rev. Rul. 8944, 19891, CB 237, the Service noted that § 901(j)(2)(C)(i) became effective for taxable years after 12/31/87.

383 The Rangel amendment was repealable only after the Secretary of Treasury certified that South Africa has satisfied the requirements of Section 311(a) of the Comprehensive Act.

384 Tony Koenderman, *New tax burden may chase more U.S. firms from S. Africa,* J. Com. & Com., Jan. 26, 1988, at 3A.

385 *See* James P. Holder & William F. Brown, *A Paradox: Why does the Federal Tax Law Penalize United States Taxpayers Who Observe the Boycott of South Africa by United States Allies,* 42 Tax Law. 211 (1989).

386 Lipton, *supra* note 351.

387 On September 16, 1986, the EC enacted bans on new investment and on imports of South African iron, steels and Kruggerrands. NEWAFRICAN YEARBOOK 199394, 341 (9th ed, 1994)(hereinafter "NewAfrican Yearbook"); *see generally* MARTIN HOLLAND, EUROPEAN COMMUNITY AND SOUTH AFRICA (1989)(hereinafter "Holland").

European Economic Community (EEC) adopted a series of mandatory trade sanctions for selected imports and exports,[388] the British Parliament enacted voluntary trade sanctions and a ban on new foreign investment.[389] Likewise, despite a strong antiapartheid movement in Germany,[390] the German government opposed mandatory sanctions at both bilateral and multilateral levels[391] and instead enacted a series of voluntary trade and investment measures.[392] In Japan, where a mandatory ban on all direct investment in South Africa had been in effect since 1968,[393] bans on Krugerrands imports and certain high technology exports to certain departments within the South African government were added in 1985[394] with bans on iron and steel imports[395] and travel restrictions being imposed a year later.[396]

In view of these differences in sanctions activity, it is not surprising that the American corporate response to official and public interest divestiture pressures took on far different dimensions than the responses of British, German and Japanese corporations to sanctions legislation enacted in their respective countries, as noted below.

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388 Holland, *supra* note 387, at 100-101.

389 During the 1988 national elections, allegations were made that the federal government had actually sold submarines in recent years to South Africa in contravention of the U.N. arms embargo. Afr. Bus. Nov. 1988, at 9; *see also* U.N. Centre on Transnat'l Corporations, Transnational Corporations in South Africa and Namibia: United Nations Public Hearings, Vol. III: Statements and Submissions, at 316-320, U.N. Doc. ST/CTC/68, (1987)(hereinafter "Statements and Submissions").

390 In 1986, the German government vetoed EC legislation which would have placed a ban on South African coal imports. Lipton, *supra* note 351, at 29.

391 Several "restrictive" trade measures in July 1986, most of which centered on sales of military equipment. Other voluntary measures were enacted in August 1987. Holland, *supra* note 347, at 101. For a list, *see* Statements and Submissions, *supra* note , 250-251 (1987).

392 Cooper & Tusenius, *supra* note 334, at 16.

393 *Id.*

394 A.E. Cullison, *Japan to review S. Africa Curbs? U.S. Sanctions may prompt stiffer measures in future,* J. Com., Oct. 6, 1986, at 22A.

395 Cooper & Tusenius, *supra* note 334, at 16.

396 Barbara Rudolph, *What are the Americans Doing,?* Time, Sept. 20, 1993, at 53.

2. *Divestment Patterns*

For most U.S. MNCs in South Africa during the 1980s, a 'complex network of local, state and federal sanctions' not only undercut the profitability of their affiliated operations there but also engrafted a perpetual public relations liability at their home offices.[397] Hence in the course of five years, the pressure of antiapartheid groups and the punitive effects of local, state and federal sanctions resulted in a massive withdrawal of American businesses and investments from South Africa.

The withdrawal unfolded in waves of divestments that were punctuated by several dramatic events. From 1984 to mid1985, about sixty American companies withdrew from South Africa, most of which held only nonequity interests and all claiming their decisions were based on purely commercial reasons.[398] Then, in August 1985, following the refusal by the U.S. to allow the International Monetary Fund to provide South Africa financial assistance, South Africa's major commercial creditors refused to the delay the rollover of $14 billion in debt.[399] Although the government negotiated a lastminute debt standstill agreement,[400] the sanctions issue now fully engaged the foreign policies of almost all Western countries.[401] In responding to the increased pressures, several MNCs substantially raised their contributions to educational funds and other philanthropic programs that benefited black South Africans[402] while others divested their interests, with Cooper Industries,[403] Emery,[404] and Dow Chemicals[405] being among the first to cite consumer pressure as a basis for their decisions.

[397] *Southern African Monitor,* Afr. Econ. Dig., Oct. 4, 1986, at 17.

[398] Charles Grant, *The Banks Abandon South Africa,* Euromoney, Dec. 1985, at 68.

[399] *See generally* JONATHAN LEAPE, SOUTH AFRICA'S FOREIGN DEBT AND THE STANDSTILL, 1985-1990 (1991).

[400] Barber & Barratt, *supra* note 340, at 299-344.

[401] For example, Coca Cola established a $10 million education fund that was controlled by black South Africans. William H. Kaempfer et al., *Divestment, investment sanctions, and disinvestment: an evaluation of antiapartheid policy instruments,* 41 Int'l Org. 457, 473 (1987)(hereinafter "Kaempfer et al"). Similarly, Goodyear spent $6 million on nonwhite educational and housing programs. Kessler, *supra* note 346, at 24.

[402] *South Africa Watchdog,* Afr. Bus. July 1986, at 10.

[403] *South Africa Watchdog,* Afr. Bus. Sept. 1987, at 11.

[404] *South Africa Watchdog,* Afr. Bus., Apr. 1987, at 9.

Passage of the Comprehensive Act in September 1986 prompted a second flurry of divestments, with two of the most prominent American corporations in South Africa, General Motors[406] and IBM,[407] announcing divestment plans within a day of each other. Then, after the Rangel Amendment was enacted in December 1987, the final wave of divestitures occurred, marked by the 1989 divestitures of the largest U.S. MNCs still operating in South Africa, Mobile Oil[408] and Goodyear.[409] Both companies cited the loss of foreign tax credits as the incident which foreclosed any possibility of maintaining profitable operations in South Africa while sanctions were in place.[410]

Hence by 1990 the once formidable sea of U.S. investments in South Africa had evaporated to a few isolated businesses continuing there despite the sanctions.[411] Most corporate interests were sold as quickly as possible to local enterprises, often

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405 After sixty years in South Africa General Motors divested its operations there in December 1986, sustaining a $50 million loss in the process. J. Com. & Com. Feb. 27, 1989 at 1A. A few years earlier, GM issued a policy statement defending its decision to remain in South Africa. *See* Statements and Submissions, *supra* note 389, at 84-93. For a history of GM in South Africa, *see* ERIC ROSENTHAL, THE ROLLING YEARS: FIFTY YEARS OF GENERAL MOTORS IN SOUTH AFRICA, (1982).

406 IBM, which sold its assets to local companies, began operations in South Africa in 1952 and had reached $175 million in sales in 1985. Koenderman, *S. Africa disinvestment mounts U.S. corporate trend adds to whites' sense of isolation*, J. Com. & Com., Nov. 21, 1986, at 3A.

407 Mobil had been operating in South Africa for 90 years. *Mobil Selling Its South Africa Units for $155 Million*, L.A. Times, Apr. 29, 1989, at 41. For a company history of its South African operations, *see* MOBIL OIL CORPORATION, MOBIL OIL IN SOUTH AFRICA, (1972).

408 Afr. Bus., July, 1989, at 9; *Goodyear plans to Leave South Africa*, L.A. Times, June 8, 1989, at 3. Goodyear sold tires in South Africa since 1916 and had manufactured tires there since 1947. Kessler, *supra* note 346, at 24.

409 *Southern Africa Monitor*, Afr. Econ. Dig., May 8, 1989, at 14. When in April 1989 Mobil Oil Corporation sold all of its entire assets at less than half their book value to the General Mining Union Corporation, a South African mining and industrial conglomerate, Mobil's chairman noted that the loss of foreign tax credits resulted in $5 million loss in 1988 alone. *Id.* Likewise, Goodyear cited the same reason in announcing the sale of its manufacturing subsidiary to an affiliate within the Anglovaal family. *Mobil agrees to sell assets to South Africa to GENCOR*, J. Com. & Com., May 1, 1989, at 7B.

410 *Southern Africa Monitor*, Afr. Econ. Dig., Feb. 28, 1987, at 17.

411 For example, Mobil recorded a net book loss of $140 million. *Mobil Selling Its South Africa Units for $155 Million*, L.A. Times, Apr. 29, 1989, at 41.

at substantial losses.[412] Some corporations sold their subsidiaries to a local holding company, as in the Firestone divestment.[413] Others, like Ford,[414] Exxon[415] and Cigna,[416] divested their assets and interests into trust funds.

Due to the comparative severity of U.S. sanctions, the pattern of American divestitures contrasts sharply with those formed by British, German and Japanese MNCs. Although the value of British direct investment in South Africa fell from $11 billion to $5.4 billion between 1982 and 1988,[417] only a handful of British MNCs completely divested their holdings[418] Instead, most British companies, like the Delta Group[419] and ICI,[420] simply became minority shareholders. Like many U.S. MNCs, some British companies increased their philanthropic activities.[421] Hence by mid1989 roughly half of the over 200 British MNCs[422] still held majority shares of their South African subsidiaries.[423] German corporations were perhaps the most resistant to the international divestiture movement. Only ten

412 The parent corporation, Firestone Tire and Rubber Company, sold its 25% stake in Firestone South Africa Limited to the majority shareholder, Federal Volksbeleggins Beperk, a local industrial holding company. *South Africa Watchdog,* Afr. Bus., Aug. 1987, at 7.

413 Ford Motor Company, in seeking to maintain its product line in South Africa while reducing its profile there, placed its 42% interest in its South African subsidiary worth $61 million in an employee trust account in exchange for "debtreduction and to keep the company in business through the next car production cycle, which ends in 1994." *Ford denies violation of antiapartheid law* , J. Com. & Com., Dec. 24, 1987, at 5A.

414 *Southern Africa Monitor,* Afr. Econ. Dig., Jan. 3, 1987, at 15.

415 *Southern Africa Monitor,* Afr. Econ. Dig., Dec. 4, 1987, at 17.

416 *Number of UK Companies in S. Africa Falls,* J. Com. & Com., Mar. 29, 1988, at 3A.

417 Fifty six British were known to have left South Africa during this period. One of the largest British MNCs in South African to fully divest was Metal Box, which sold its 25% stake in its subsidiary, Robor Industrial Holdings, to Barlow Rand, for roughly $50 million. *South Africa Watchdog,* Afr. Bus., May, 1988, at 8. The divestment of Standard Charter, one of South Africa's largest commercial creditors, stood as one of the dramatic moments during the sanctions era. *South Africa Watchdog,* Afr. Bus. June 1987, at 9.

418 *South Africa Watchdog,* Afr. Bus. Feb. 1987, at 7.

419 *Southern Africa Monitor,* Afr. Econ. Dig., Jan. 15, 1988, at 25.

420 For example, British Petroleum spent over $44 million in establishing an education and housing fund in Cape Town in 1986. *Southern Africa Monitor,* Afr. Econ. Dig., Nov. 22, 1986: 15.

421 *International Briefs,* J. Com., Aug. 10, 1989, at 4A.

422 *South Africa's Face of the Future,* Mgmt Today, Sept. 1991, 68, at 71.

423 Financial Sanctions Against South Africa, *supra* note 359, at 53.

German corporations withdrew from South Africa,[424] with prominent German MNCs such as Siemens, Volkswagon, Linde, AEG, and Daimler Benz choosing to stay.[425]

The pattern of Japanese divestitures also reflects a general choice of reduced ownership over complete divestment. Since most Japanese companies operated in South Africa through distribution arrangements,[426] the departure of American and European companies between 1985 and 1987 resulted in immediate market share gains for their the licensed subsidiaries.[427] Thus in Japan became South Africa's largest trading partner,[428] prompting vigorous complaints in the U. N. General Assembly.[429] Thereafter, most Japanese MNCs simply limited their business activities in South Africa.[430]

Political reform eventually developed under the guidance of Frederik W. de Klerk, who was elected President in August 1989. A few months after imprisoned ANC leader Nelson Mandela was released in February 1990, the ban on political opposition was lifted and some of the cornerstones of apartheid society, including racial restrictions involving the purchase of land, were abolished.[431] In 1991 the ANC and other parties entered direct negotiations with the de Klerk government over constitutional change and the transition to majority rule.[432]

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424 *South Africa Watchdog*, Afr. Bus. Sept. 1987, at 11.

425 Cooper & Tusenius, *supra* note 334, at 138144. In fact, Japan's major automobile manufacturers Honda, Isuzu, Mazda, Toyota and Yamaha all held distribution agreements with local assembly companies. An exception was Mitsubishi Corporation which one one of the few corporations which owned a branch office in South Africa. *Id.*

426 For example, sales of Hitachi computer through its local distributor sharply increased after IBM's divestment. *South Africa Watchdog,* Afr. Bus. Dec. 1987, at 9.

427 The increased trade resulted in part from the relative strength of the yen visa vis the U.S. dollar. *Id.* It was an ironic development as well, in that the South African ethnic identification system treated Japanese as 'honorary whites.' Sanford J. Ungarad and Peter Vale, *South Africa: Why Constructive Engagement Failed,* 64 Foreign Affairs 234 (1985/1986).

428 *South Africa Watchdog,* Afr. Bus., Dec. 1988, at 10.

429 For example, the Matsushita Electrial Industrial Company left the following year. *Matsushita to close South Africa unit,* J. Com. & Com., Dec. 7, 1989, at 5A.

430 *Id.*

431 Africa South of the Sahara, *supra* note 24, at 799-803.

432 *Britain to lift ban on S. Africa,* J. Com., Feb. 21, 1990, at 14A.

The Mandelade Klerk dialogue prompted changes in the foreign policies of the leading industrialized countries, as noted below.

3. *Lifting of Sanctions*

De Klerk's initial reform efforts soon gather international support. Upon Mandela's release, Great Britain immediately abolished its economic sanctions.[433] Thereafter the EEC revoked its trade bans[434] while Japan lifted its trade bans in October 1991[435] and eliminated all remaining sanctions a year later.[436]

The dictates of U.S. foreign policy on removal of South African sanctions required a incremental approach to be taken. In June 1991, U.S. President George Bush abolished most of trade, financial and investments bans and restored South Africa's eligibility for export credits under the U.S. Export Import Bank.[437] Then, after the whitesonly referendum in March 1992 evinced public support for de Klerk's reforms,[438] the U.S. foreign tax credit election was reinstated.[439]

Between 1991 and the end of 1993, numerous trade delegations shuttled between Johannesburg and capitols throughout the world. Although the trajectory of political reform there still

[433] The foreign ministers voted to lift the sanctions on April 15, 1991. *Southern African Monitor,* Afr. Econ. Dig., Apr. 22, 1991, at 11.

[434] A.E. Cullison, *Japan Lifts Most Trade Sanctions In Effort to Speed S. Africa Reforms,* J. Com., Oct. 23, 1991, at 4A.

[435] Frank Ruddy, *South Africa Opportunities and Uncertainties,* Wash. Times, Nov. 28, 1993, at B3.

[436] Executive Order #12769.

[437] In whitesonly referendum on March 17, 1992 paved the way towards multiparty negotiations over constitutional changes and the establishment of transitional period to democratic rule. By February 1993, over 20 political parties agreed to a new constitutional format. Africa South of the Sahara, *supra* note 24, at 798.

[438] As of July 10, 1992, the Internal Revenue Service eliminated South Africa from the list of countries subject which are ineligible for foreign tax credits under § 901(j) but noted that the former income tax treaty would not resume operation. Rev. Rul. 9263, 92 FED par. 46, at 433. The State Department determined that South Africa satisfied the requirements of § 311(a) of the Comprehensive Act on July 10, 1991. Hence taxes paid on income generated after that date became creditable. Philip d. Morrison, *United States: Taxes Paid to South Africa are now creditable, explains Morrison,* 4 Tax Notes Int'l 869 (Apr. 27, 1992).

[439] *Id.*

remained uncertain,[440] new investments came from Singapore[441] and Taiwan,[442] countries which previously had only insubstantial economic ties with South Africa. In addition to the firms which never left, British,[443] German[444] and Japanese[445] MNCs made began making initial inquiries into profitability of returning to South Africa.

In contrast, most American corporations took more of a "wait and see" attitude to the reforms in South Africa,[446] with only a few companies making longterm investments.[447] Nonequity investments continued to be the path chosen by most U.S. corporations in returning to South Africa.[448] In fact, between 1991 and 1992 "only 28 American companies made new, direct capital investments in South Africa"[449] compared to over a hun-

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440 Salil Tripathi, *S.Africa keen on S'pore investments, says de Klerk,* Bus. Times, June 9, 1992, at 3.

441 For example, shortly after their government negotiated a tax treaty with South Africa, several Taiwanese textile corporations established operations in the impoverished areas once known as the 'independent homelands.' Joe Castro, *S. African Garment Industry Frayed; Asian Competition Batters Local Firms in Homelands,* J. Com. & Com., May 5, 1993, at 1A.

442 *See T&B gains edge in South Africa,* Int'l Freighting Wkly., Sept. 14, 1992, at 7; *ICI widens interest in S. Africa,* Independent, Oct. 14, 1993, at 36.

443 *German firm buys 51% stake in CME,* Bus. Day, Jan. 24, 1991, at 1; *Operatives Standbein in Suedafrika,* Europa Chemie, Aug. 5, 1991, at 14.

444 *Madza to buy into South Africa,* Int'l Herald Trib., Oct. 17, 1991, at 17.

445 Gillian Findlay & Riccardo A. Davis, *U.S. Marketers cautious on S. Africa,* Advertising Age, Oct. 25, 1993, at 58 (hereinafter "Findlay & Davis").

446 Corporations making their first investments in South Africa include Lotus Development and CPS Chemical. Paula Green, *U.S. Investors Take Indirect Path in S. Africa,* J. Com. & Com., June 26, 1992, at 1A.

447 When full trading relations were restored South Africa, Proctor and Gamble immediately entered into licensing and franchising agreements with local businesses. Protector & Gamble repurchased its former South African subsidiary. *U.S. States, Cities continue to lift economic sanctions against South Africa,* BNA Int'l Trade Daily, Dec. 28, 1993, *available in* LEXIS, Nexis Library, BNADNEWS. Austin's International negotiated a franchising agreement in South Africa. Melinda Zisser, *Austin's Signs 35Restaurant Franchise Deal with Republic of South Africa,* S. Fla. Bus. J., Aug, 13, 1993, at 9. Also, Hertz Corporation returned in 1993 under a new franchising arrangement. *Hertz reenters South Africa; signs car rental franchise agreement,* PR Newswire, November 13, 1993, *available in* LEXIS, Nexis Library, BUSALA File. Hertz divested all of its South African interests in 1987. *South Africa Watchdog,* Afr. Bus., Oct. 1987, at 6.

448 Rudolph, *supra* note 397, at 53.

449 Philip Gawith, *S. Africa investment up but so are the outflows: Divestment and investments abroad amount to more than double inward inflows,* Fin. Times (London), Nov. 26, 1992, at 4.

dred investments by non-U.S. entities.[450] Their reticence to make equity investments there stemmed from both the continuity of federal, state, and local sanctions through 1992 and the absence of a set of management policies[451] deemed politically correct by the various interest groups[452] that scrupulously monitor business practices in South Africa.[453] Hence most of the 250+ U.S. companies that were operating in South Africa by the end of 1993 did so through distribution operations,[454] licensing arrangements[455] or other limited contract agreements with local partners.[456]

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[450] These concerns stemmed from the fact that 26 states, 90 cities and 23 municipalities still maintained sanctions on South African investments by June 1993. Charles Thurston, *Business Gropes for Politically Correct S. Africa Stance*, J. Com. & Com., June 22, 1993, at 3A. Training programs for black South African executives have been conducted in the United States. *Black South African Executives in U.S. training program arrive in Washington for business and economic briefing,* PR Newswire, June 15, 1993, *available in* LEXIS, Nexis Library, BUSANL File. For a discussion of the socially productive corporate practices in postaparthied South Africa, *see* S. Prakash Sethi, *Operational modes for multinational corporations in postapartheid South Africa: a proposal for a code of affirmative action in the marketplace,* 12 J. Bus. Ethics, 1 (1993). The importance of establishing acceptable corporate practices is reflected in Digital Equipment Corporation's return to South Africa in September 1993 in which it specifically aligned its subsidiary there with the first blackowned computer company in South Africa. *Country report, South Africa,* Economist Intelligence Rpt., no. 3, 1993, *available in* LEXIS, Nexis Library, BUSANL FILE.

[451] Such groups include the Interfaith Center for Corporate Responsibility, Investor Responsibility Research Center, and American Committee on Africa. *See MNCs operating in South Africa still pressured to divest,* Global Fin. Markets, Feb. 12, 1992, *available in* WESTLAW, BUSINTL Database.

[452] Maria Scott, *South Africa: Ethics Men Take Stock of New South Africa*, Observer, Dec. 12, 1993, at 12. For a brief discussion on a mutual fund management company that has investments in South Africa, *see Is South Africa the next emerging market?* Business Wire, Sept. 24, 1993, *available in* LEXIS, Nexis Library, BUSANL File.

[453] *Business in South Africa,* Economist, Dec. 18, 1993, *available in* LEXIS, Nexis Library, BUSANL File.

[454] By early 1994 over 20 states, 9 counties and 30 cities had yet to repeal their sanctions. *U.S. states, cities continue to lift economic sanctions against South Africa,* Dec. 28, 1993, *available in* LEXIS, Nexis Library, BNADNEWS File.

[455] Paula Green *Trade Talk Paula Green,* J. Com. & Com., Dec. 22, 1992, at 3A.

[456] Following Mandela's September 24th speech to the General Assembly, the United Nations abolished most nonmandatory economic sanctions in October and removed its long standing oil embargo on December 8, 1993. *South Africa: UN lifts oil embargo,* BBC, Dec. 14, 1993, *available in* LEXIS, Nexis Library, INTNews File. The oil embargo was enacted in December 1977. Anthony Goodman, *United Nations: U.N. ends oil embargo against South Africa,* Reuter Newswire, Dec. 9,

Once an agreement over constitutional change appeared imminent, de Klerk and Mandela separately lobbied Western leaders and the United Nations[457] for the abolition of all remaining sanctions.[458] Acceptance of a new constitutional format and a schedule set for democratic elections under an interim government called the Transitional Executive Council (TEC) was reached in September 1993.[459] Congress then passed the South African Democratic Transition Support Act of 1993[460] which President Bill Clinton signed into law in November 1993. After this law abolished most of the remaining federal sanctions,[461] institutional investors and American colleges and universities ended their divestment policies and began considering investments in an independent South Africa.[462]

Hence the scope of U.S. sanctions forced the vast majority of U.S, corporations to divest their entire equity portfolios, thus substantially diminishing their commercial ties with South African business and industries. Additionally, the prolonged length of U.S. sanctions contributed to the relatively late return of U.S. corporations to the search for investment opportunities there.

B. *Market Changes in South Africa*

The sanctions era certainly changed, if not altogether revamping, the competitive structure of many consumer markets in South Africa. Several broad features are noteworthy. To begin with, the hyperinflationary economy fueled a process of business selfabsorption. Following the debt crisis of 1984-

1993, *available in* LEXIS, Nexis Library, INTNEWS file. All remaining nonmandatory sanctions, with the exception of the arms embargo, were abolished when the TEC assumed the reigns of presidential power on December 6, 1993. Econ. Intelligence Unit, *Country Report: South Africa,* 9 (1st qtr, 1994).

457 *Sweden: Mandela and De Klerk urge Swedish Businessmen to invest in South Africa,* BBC Monitoring Service, Dec. 13, 1993, *available in* WESTLAW, INTNEWS Database.

458 Africa South of the Sahara, *supra* note 24, at 799-800.

459 PL 103149; HR 3225, S 1493.

460 The bill became law on November 23, 1993. *President Clinton signs legislation lifting sanctions against South Africa,* BNA Washington Insider, Nov. 26, 1993, *available in* LEXIS, Nexis Library, BNADNEWS File.

461 *See College Reverse Divestment Plans,* N.Y. Times, Nov. 28, 1993, at 33.

462 See notes and accompanying text, *infra.*

1985[463] South African citizens and companies took over $5 billion out of the country in a five year period.[464] During that time South Africa went from its historical position as a net capital importer to a net capital exporter.[465] In fact the dearth of foreign capital created a cycle of declining stock values and local repurchases, to the point where corporate crossshareholdings placed more than 80% of all the shares listed on the Johannesburg Stock Exchange into the hands of South Africa's five major conglomerates.[466] Even the parastatals absorbed local assets, as the government came to own a third of all fixed assets in South Africa.[467]

The loss of foreign private finance resulted in constraints on market diversification and industry development. Local finance stiffened in response to the government's exchange controls. Companies returned greater portions of their earnings and profits into maintenance expense in order to halt declines in their permanent capital accounts. Declining productive outputs and negative industry growth also arose from the loss of technological inputs.[468]

Lastly, the divestment patterns of the main industrialized countries have actually leveled some of the market share disparities which previously were dominated by American and European MNCs. Now corporations from Singapore, Taiwan, and other countries add to the field of traditional competitors operating in South Africa.

Current market conditions favor those corporations which can quickly infuse local companies with finance and technological inputs.[469] Many industries, especially those involved

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463 Millard W. Arnold, *Engaging South Africa after Apartheid*, 87 Foreign Pol'y 139, at 143 (1992).

464 Lachman & Bercuson, *supra* note 28, at 32.

465 *PreElection Nerves, PostElection Questions*, Investors Chronicle, Apr. 1, 1994, *available in* LEXIS, COMPNY Library, MANEWS File.

466 Market Reports, *South Africa Overseas Business Report*, July 20, 1993, *available in* LEXIS, Nexis Library, BUSANL File (hereinafter "Market Reports, July 20, 1993").

467 Keller, *supra* note 14.

468 Market Reports, Dec 15, 1993

469 Id.

higher level manufacturing, also require an influx of managerial expertise.[470]

In these circumstances existing business relationships provide distinct advantages in that changes in management and plant restructuring can be phased in gradually as opposed to the confusion of establishing an entirely new set of operations following a successful merger. However, in divesting all equity holdings, few American MNCs maintained the types of nonequity arrangements that would now facilitate an expansion of local businesses. This pattern contrasts with those formed by the partial divestitures and subsequent investment by British, German and Japanese MNCs. Because most of these companies reduced but did not eliminate their equity holdings during the sanctions era, they are presumably in a better position to meet rapid expansion of operations and services.

An obvious competitive difference between American MNCs and their European competitors relates to the operation of double taxation treaties. As noted earlier, the tax treaty between the United States and South Africa terminated in July 1987. Although the Service began informal treaty talks with their South African counterparts six months before the April elections,[471] official negotiations did not commence until June 1994 and were not completed as this Comment went to publication. It is certain, however, that the new treaty will not restore the previous one.[472]

Unlike the U.S., neither Germany[473] nor Great Britain[474] abolished their tax treaties with South Africa during the sanc-

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470 Treaty negotiations may have started informally in 1992, but protests from Congressional leaders prevented the Treasury Department from pursuing formal negotiations. *See United States: Rangel urges Treasury to delay tax treaty negotiations with South Africa,* 4 Tax Notes Int'l 1310 (June 22, 1992).

471 Rev. Rul. 9263, 92 FED par. 46, at 433.

472 Agreement Between the Federal Republic of Germay and the Repulic of South Africa for the avoidance of Double taxation with respect to taxes on Income.

473 Schedule Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of South Africa for the Avoidance of Double Taxation, U.K.R.S.A., Jan. 1, 1987. The May 1962 agreement remains in effective today. *See* 93 Tax Notes Int'l 919.

474 Schedule Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of South Africa for the Avoidance of Double Taxation, U.K.R.S.A., Jan. 1, 1987. In fact, the BritishSouth Africa double tax treaty contains a tax sparing measure which treats as creditable the amount of taxes payable in the host country irrespective of actual

tions era. Thus the favorable foreign tax credit and withholding taxes rates were available to MNCs within these countries.[475] Additionally, companies operating as a CFC there are excluded from British CFC legislation.[476] In addition to these traditional sources of foreign investment, South Africa has recently concluded tax treaties with Poland,[477] Taiwan,[478] and France.[479]

Hence U.S. companies reinvesting in South Africa face a number of competitive challenges, due to the length and scope of U.S. sanctions and subsequent changes in South Africa's domestic markets. The competitiveness of U.S. MNCs seeking South African investments will also depend on the ability of financial managers to harmonize the current investment and tax regulations in South Africa with U.S. tax law pertaining to interest deductions.

PART III. THE TAX DISADVANTAGE AND COUNTERVAILING LOCAL REGULATIONS

In examining the investment and tax regulations applicable to new investments in South Africa, Part III integrates the discussion of the preceding two parts by illustrating how the new interest expenses rules disadvantage American MNCs in their competition with British, German and Japanese multinationals for South Africa's emerging markets and investment opportunities. Specifically, two features of the current tax system pose significant obstacles for U.S. MNCs seeking to invest there.

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payment. That is, even if the subsidiary is not taxed in South Africa due to, for example, a tax holiday, the amount it would have had to pay is credited to the parent's U.K. tax liability.

475 John G. Goldsmith, *U.K. Inland Revenue releases list of countries excluded from application of CFC legislation*, 7 Tax Notes Int'l 1027, at 2038 (Oct. 25, 1993).

476 Janusz Fiszer, *Poland signs tax treaty with South Africa,* 7 Tax Notes Int'l 1354 (Nov. 29, 1993).

477 On February 14, 1994, Taiwan and South Africa entered into a double taxation treaty. *More on TaiwanSouth Africa treaty,* Int'l Bureau of Fiscal Documentation, Mar. 24, 1994, *available in* LEXIS, Nexis Library, IBFD File.

478 On November 8, 1993, France and South Africa entered into a double taxation treaty. *FranceSouth treaty,* Int'l Bureau of Fiscal Documentation, *available in* LEXIS, Nexis Library, IBFD File.

479 Pierre du Toit, *South Africa: Asset Financing,* World Tax Rep. Sept. 1993, *available in* LEXIS, FEDTAX Library, WLDTAX File.

A. *South Africa Taxes*

South Africa taxes resident nonmining corporations through the use of residency and source principles and there are no provisions for group or consolidated tax treatment for affiliated corporations.[480] Non-mining corporations are governed by the Companies Act of 1973, which "regulates the formation, conduct of affairs and liquidation of all companies"[481] Local subsidiaries are defined as "companies" incorporated in South Africa which are owned by non-residents.[482] Conversely, a branch is an "external company"[483] and is taxed at the same rate as companies.[484] Partnerships are also permitted, although no partnership is allowed to have more than 20 partners.[485] As in the United States, partnerships are unincorporated businesses wherein profits immediately accrue to partners.[486] Since joint ventures are not specifically defined in South African tax law, partnerships are generally the vehicle through which such ventures are formed.[487]

On July 20, 1993, the South African government passed the Income Tax Act of 1993 ("ITA 1993")[488] which established a dual corporate tax system.[489] ITA 1993 imposes a 40% tax on declared profits and a 15% "Secondary Tax on Companies ("SCT")"[490] on undistributed profits. The latter is "designed to

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480 Market Reports, *South Africa Overseas Business Report,* July 20, 1993, *available in* LEXIS, COMPNY Library, BUSOPP File.

481 Deloitte, Touche, Tohmatsu, *supra* note 95, at 63.

482 PRICE WATERHOUSE, DOING BUSINESS IN SOUTH AFRICA 24 (Suppl. 1992)(hereinafter "Price Waterhouse, *South Africa*").

483 Deloitte, Touche Tohmatsu, *supra* note 95, at 61

484 *Id.* at 77.

485 Williams & Eskinazi, *South Africa,* in EFFECTIVE TAX STRATEGIES FOR CORPORATE ACQUISITIONS, at 241 (P. Cooke ed., 1989)(hereinafter "Williams & Eskinazi").

486 Deloitte, Touche Tohmatsu, *supra* note 95, at 63.

487 Income Tax Act No. 113 of 1993 (GN 1280, *GG* 14979, 20 July 1993), as cited in Eisenberg, *supra* note 51, at 20, note 64. *See also Tax Cuts Offset by Dividend Levy in South Africa,* Worldwide Fin. Reg., May 3, 1993, *available in* LEXIS, TAX Library, TAXANA, File.

488 Marius van Blerck, *South Africa's New Dual Tax System,* 8 Tax Notes Int'l 311 (1994)(hereinafter "Blerck").

489 John Turro, *Tax reform: South Africa prepares for economic change,* 7 Tax Notes Int'l 728, at 729 (Sept. 20, 1993).

490 Basil Wunsh, *South Africa, in* DIFFERENCES IN TAX TREATMENT OF FOREIGN INVESTORS: DOMESTIC SUBSIDIARIES AND DOMESTIC BRANCHES, 176 (J. Forry, ed., 1984)(hereinafter "Wunsh").

compel the distribution of a company's profits by way of dividends"[491] Withholding taxes on dividends sent by the local subsidiaries to their foreign shareholders escaped significant revision under ITA 1993, including the exemption of such taxes for local subsidiaries in which are 50% or more South African interests total at least 50%.[492] Interest income received by or accrued to a taxpayer from a South African source is taxable.[493] As applied to non-residents, the actual source of interest is determined by where the credit was made available by the creditor to the debtor.

With regard to interest expense, local subsidiaries of foreign corporations may deduct interest under Section 11(a) of the Income Tax Act of 1962 so long as it was 'incurred in the production of income.'[494] Although "interest payable by a South African subsidiary to an overseas parent company or other lender is deductible,"[495] interest paid on loans used to acquire other companies is not.[496] Hence it appears that foreign corporations which incurred indebtedness in acquiring a South African company could not deduct the interest on the purchase price if the acquisition consisted solely of assets or shares. Still, the deductibility of interest owed by local subsidiaries to their overseas companies from inter-company loans is at the discretion of the Commissioner of Inland Revenue under § 11(b) of the 1962 Income Tax Act.[497] Often tax treaties specifically covered interest deductions. For example, both the German and British tax treaties with South Africa limited the amount of tax imposed on interest income sourced in South Africa to 10%.[498] Likewise, Article IV of the abolished U.S.South African double tax treaty exempted South African taxes on inter-company loans that were sourced in the United States.[499]

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491 Coopers & Lybrand, INTERNATIONAL TAX SUMMARIES, 82 (1993)(hereinafter "Coppers & Lybrand").

492 *South Africa: Withholding tax,* World Tax Rpt, Mar. 1993, *available in* LEXIS, FEDTAX Library, TXTP File.

493 Deloitte, Touche Tohmatsu, *supra* note 95, at 85.

494 Wunsh, *supra* note 490, at 169.

495 Deloitte, Touche Tohmatsu, *supra* note 95, at 85.

496 *Id.*

497 *Id.* at 169

498 *Id.* at 169-170.

499 *South Africa: Tax on Interes to NonResidents,* World Tax Rep., August 1992, *available in* LEXIS, FEDTAX Library File.

However, in June 1992 the Finance ministry announced that 'all interest in the hands of companies not managed or controlled in South Africa will be completely exempt from tax.'[500] Interest income paid by CFCs to nonresidents are no longer subject to withholding taxes, a change that encourages foreign corporations investing or operating in South Africa to use onlending in capitalizing or funding the working capital of their affiliates.

Since interest payments are made in commercial rands, all foreign loans must first be approved by the Exchange Control (discussed momentarily).[501] If approval is granted, the amount of interest paid to the non-resident corporation is tax deductible on the company's South African tax liability so long as the loan is used for the production of taxable income and the interest rate is line with current local rates.[502]

B. *South Africa Currency Exchange*

Exchange control involves the regulation of the movement of assets and activities via domestic and foreign currencies. Two basic features occupy this discussion: control of all company lending entering the country and the dual currency exchange system.

In August 1985, at the earliest stages of the flight of capital out of South Africa, the government reintroduced a dual or two-tier exchange rate for its currency in order to bolster its sagging balance of payments and avoid bankruptcy.[503] The rand was divided into commercial and financial units, with the former serving as the official exchange rate while all foreign investment and purchases of securities and other assets by nonresidents are denominated in the latter.[504] Financial rands are

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[500] Deloitte, Touche Tohmatsu, *supra* note 95, at 119.

[501] *Id.* at 20-21.

[502] Philip Gawith, *SA to begin loan payback next year*, Fin. Times, Sept. 28, 1993, at 7. The twotier system was first introduced in March 1968 and repealed in September 1975. Katherine Munro, *Monetary Policy, Commercial Banking and the Political Imperative, 196585,* in BANKING AND BUSINESS IN SOUTH AFRICA, 125 (S. Jones, ed., 1988).

[503] *South AfricaForeign Economic Trends,* Market Reports, Sept. 15, 1993, *available in* LEXIS, Nexis Library, BUSALA File ("Market Reports, September 15, 1993").

[504] Deliotte, Touche, Tohmatsu, *supra* note 95, at 20.

held and used by non-residents in South Africa through the approval of the Exchange Control.[505]

As an emergency measure, the dual currency protected the government's foreign currency reserves and stemmed price rises in an otherwise hyperinflationary economy.[506] The discount between the financial rand and the commercial rand has floated over the past nine years from 20% to 40%,[507] providing foreign investors with initial and at times substantial currency gains at the cost of penalizing future profit repatriation from affiliated operations.[508] However, local affiliates of foreign corporations still pay dividends and interest payments in commercial rands.[509]

The dual currency system has adversely affected South Africa's capital markets. Although the financial rand's discount rate provides U.S. investors with immediate currency gains, such gains are subsequently lost once the Rand units are reconverted into U.S. dollars, i.e., by remitting earnings to the parent corporation in U.S. dollars. Exchange rate losses on loans secured in South Africa cut into the local company's profits.[510] Despite these difficulties, the South African Reserve Bank is expected to maintain the dual system to mid1995 or at least until sustained export growth permits a single currency.[511]

Historically, South African Exchange Control policies have favored equity based investment in South African subsidiaries because the "interest payable to the overseas parent company is deductible" and is taxed only once, whereas dividends are taxed (income tax on subsidiary when earned and withholding tax when remitted).[512] As such the government has closely monitored the level of local borrowing of for both external companies (i.e. foreign branches) and South African companies in which at

505 Philip Gawith, *Survey of South Africa Open for Investment*, Fin. Times, Nov. 18, 1993, at 38.

506 Thomson, *supra* note 17.

507 Sean Ross, *S. African Bank Official Wary of Early Abolition of Currency*, J. Com., July 19, 1994, at 3a.

508 Deloitte, Touche, Tohmatsu, *supra* note 95, at 119.

509 This has been the experience of a British manufacturer, The Group 600.

510 Tony Hawkins, *Survey of South Africa Open for Investment*, Fin. Times, Nov. 18, 1993, at 37; Gawith, *supra*, note 449, at 38.

511 Wunsh, *supra* note 490, at 167.

512 Coopers & Lybrand, *supra* note 491, at 82.

least 25% of its shares are held by nonresidents.[513] All companies or partnerships so owned are called "affected persons."[514] The restriction on the level of local borrowing is limited to a percentage of its "total effective capital employed,"[515] a calculation based on a ratio of foreign to local equity holdings. Section 3(1)(f) of the exchange regulations provides the following calculation:[516]

50% + ((% South African interest)/(% nonresident interest) x 50%)

If for example the foreign equity of a local subsidiaries reaches 75%, the relevant lending limitation equals 66.7%.[517] For a joint venture, however, if the South Africa interest is 50 per cent or more, the venture is permitted to borrow from local lenders up to 100 per cent of total shareholder's equity.[518]

In November 1992, the Finance Ministry imposed regulations which require most foreign investments to be funded with foreign loans.[519] All foreign loans remain denominated in commercial rands, however.[520] Dividends paid by local subsidiaries which are at least 25% owned or controlled by non-residents must also be approved by the Exchange Control before repatriation.[521]

Overall, these changes encourage foreign corporations to finance their South African investments by way of offshore financing. Since interest payments made by CFCs in South Africa are now tax free, inter-company lending is likely to increase. Additionally, the November 1992 regulations concerning foreign loans point clearly to this conclusion. For U.S.

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[513] *Id.*

[514] Among other items, effective capital employed includes "overdrafts, local discounting, financial leasing of capital equipment, mortgage bonds and shares and debentures not subscribed for by equity shareholders." ERNEST & YOUNG, DOING BUSINESS IN SOUTH AFRICA 14 (1990).

[515] Wunsh, *supra* note 490, at 165-66.

[516] Deloitte, Touche Tohmatsu, *supra* note 95, at 23.

[517] Eisenberg, *supra* note 51, at 19.

[518] *South Africa,* Worldwide Financial Regulations, Jan. 31, 1994, available on WESTLAW

[519] Deloitte, Touche Tohmatsu, *supra* note 95, at 21.

[520] Ernest & Young, *supra* note 514, at 14.

[521] C. Shepard, *Tax Obstacles and Incentives to Inward Investment in Non-member countries: The Experience of the United Kingdom, in* TAXATION AND INTERNATIONAL CAPITAL FLOWS, 105 (Organisation for Eonomic Cooperation and Development, comp. 1990).

MNCs, these regulations may feature prominently in the decision making process concerning South Africa as an investment site, especially for manufacturing companies with excess foreign tax credits.

It may be argued, then, that the incongruity of U.S. interest expense rules and South African regulations has until recently been overshadowed by the continuity of sanctions and political uncertainties surrounding the transition to majoity rule. Most American companies operating or investing there since the mid 1980s have been limited to nonequity arrangements, which may be considered an inadequate means of sustaining market shares during a time when a influx of foreign direct investment. With the sanctions removed and foreign investment expected to pour into the South African economy over the next decade, the incompatibility of these sets of regulations now have greater import.

C. *Impacts on the U.S. Corporate Return to South Africa*

It is asserted here that the tax treatment of interest expense within affiliated corporate group not only affects the incidence of double taxation U.S. parents face but their investment behavior as well. Because tax considerations are a key factor in the "manner in which [an] investment is financed,"[522] U.S. manufacturing MNCs may discover that the choice of entity is particularly constrained when discussing South African investments.

However, the 15% withholding tax is ten percentage over the statutory definition and when combined with the 40% corporate rate, South Africa falls into the high tax category.

Secondly, the exchange control regulations are designed to protect South Africa's financial markets, and thus encourage foreign investors to in effect begin their own finance. The deductions for acquisition indebtedness are narrowly drawn, complicating further efforts by U.S. MNCs to place debt on the target when investing there.

Hence U.S. manufacturing MNCs encounters a dilemma in returning to South Africa, as most U.S. manufacturers MNCs with excess foreign tax credits desire local borrowing as a

[522] Deloitte, Touche, Tohmatsu, *supra* note 95, at 92.

means of maximizing their U.S. foreign tax credits. The following discussions assume an American manufacturing MNC, referred to as U.S. Parent, desires a South African affiliate which will produce active, general limitation income. Four entities are examined, a noncontrolled subsidiary, CFCs, corporate foreign joint ventures and joint ventures structured as partnerships, with foreign tax credit and interest expense apportionments centering each discussion.

1. *Noncontrolled Subsidiaries*

Few advantages accompany the choice of a non-controlled or 10/50 subsidiary. Among them is the ability to deduct various expenses charged to it by its parent company, including interest.[523] Assuming the majority stake is held by South African interests, the subsidiary would be able to borrow maximum allowed under the exchange control regulations.

However, in the absence of a favorable tax treaty provisions that many of their European competitors enjoy, U.S. minority-owned subsidiaries in South Africa are taxed currently on their earnings and taxed at the highest withholding tax rates when dividends are remitted.[524] Then once the U.S. parent receives the dividend, it must place the accompanying foreign tax credits in a separate limitation basket. Since the South African corporate tax rate is five percentage points higher the U.S., the excess credits are lost forever. Also interest income remitted by a non-controlled § 902 corporation would be subject to the high withholding tax limitation basket, wherein only one-third of the 15% South African tax paid on such income would be creditable.[525]

2. *CFCs*

From a U.S. tax perspective, establishing a non-controlled 10/50 subsidiary in South Africa by way of debt based, asset acquisitions may represent a logical progression for companies which are already operating licensing and distributions arrangements there. For example, Coca Cola recently announced

[523] Coopers & Lybrand, *supra* note 491, at 82.
[524] I.R.C. § 904(d)(2)(E)(ii).
[525] *Id.*

the purchase of the local company that had been servicing CocaCola bottlers since 1987.[526]

Similar problems arise with the establishment of a controlled foreign corporation. If a CFC is chosen, an inter-company loan increases the value of the parent's overseas assets, thereby placing a larger portion of group interest expense overseas. The interest payments are characterized as passive income and under the CFC netting rule the parent's interest expense in securing the loan is allocated against foreign source income. In fact it is possible that a U.S. parent corporation could lose up to a half of interest expense deductions due to obtaining CFC status and having high debt to equity ratios within the affiliated structure.

Although the CFC netting rule directs most U.S. MNCs to avoid inter-company lending, South African tax law actually favors such lending as local subsidiaries are permitted to deduct interest paid on loans from related party creditors so long as the loan proceeds are used to produce income.[527] Additionally, interest payments made to U.S parent are exempt from under the new regulations.

3. *Corporate Joint Ventures*

A better alternative is perhaps to establish a foreign joint venture as a CFC. That is, U.S. MNCs could structure the ownership requires such that the CFC rules apply to it. This would enable the US Parent to defer the venture's earnings (other than those of subpart F). Also, the dividends received from the venture would be handled by subpart F and are not subject to a separate foreign tax credit limitation. Hence the foreign source income that is taxed at 40% will not result in a loss of 5% of the foreign taxes paid, but rather creates a 5% excess credits which may be soaked up by other lowtaxed foreign source income placed in the active source residual limitation basket.

Secondly, CFC status enables the U.S. parent to characterize the interest paid to the parent under the look through rules of § 904(d) and Reg. 1.9045. Here again passive income is avoided, becoming instead general source income. The same

526 Deloitte, Touche, Tohmatsu, *supra* note 95, at 119.

527 *ANC Begins Talks With Germany on Protecting Investors in Africa*, J. Com., at 10A.

benefits for onlending accrue as well. However, the presumption here is that the U.S. manufacturers needs to reduce its excess foreign tax credits.

4. *Joint Ventures as Partnerships*

Starved of technology inflows for almost a decade, many South African businesses are presently forming joint ventures with foreign corporations as a means of securing a steady source of inputs. Joint ventures appear to be particularly beneficial for those U.S. manufacturers which are investing in South Africa for the first time and which need local expertise in marketing their products. Indeed, the ANC government sees joint ventures as key economic stimulants and actively promotes their use.[528] These policy pronouncements have only heightened the race among foreign corporations for attractive, profitable "local partners, especially among South Africa's hundreds of black entrepreneurs."[529]

The race in fact began a few years ago. In fact, Heinz, one of the few U.S. MNCs that began searching for South African companies in the early 1990s, is expected to announce a joint venture with a South African by 1995 and use the venture as 'springboard' to regional markets. During 1993, several substantial joint ventures were announced from a variety of industries, including in ferroalloys mining,[530] electronics manufacturing,[531] pharmaceuticals[532] and prossessed foods.[533]

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[528] Loeb, *supra* note 27, at 18.

[529] Nippon Renko, the leading supplier of ferroalloys in Japan, negotiated a joint venture arrangement with South Africa's largest ferrochrome producer, Samancor. If completed, the arrangement will enable Japan to maintain its preponderant position in the stainless steel industries. *Country report: South Africa*, Economist Intelligence Unit, No. 3, 1993, *available in* LEXIS, Nexis Library, INTNEWS File.

[530] Likewise, a South Korean electronics manufacturer Daewoo formed a joint venture with Anglo-American. Findlay & Davis, *supra* note 445, at 58.

[531] For example, the leading South African pharmaceuticals company formed a joint venture with a Swedish firm. *Astra i samagt bolag i Sydafrka*, Dagnes Industri, Sept. 22, 1993, at 12. Another corporation, Pharmacia, established a similar arrangement in December 1993. *Pharmacia to set up S. Africa unit.*, Fin. Times, Dec. 23, 1993, at 18.

[532] In October 1993 Pillsbury established a 5050 joint venture. Findlay & Davis, *supra* note 445, at 58.

[533] Rory Channing, *Pepsi, Hailing a New Generation, Says It's Returning to South Africa*, J. Com & Com. , June 7, 1994, at 3A.

U.S. MNCs have made surge of late, with Pepsi[534] announcing a joint venture this past summer.

As in the choice of subsidiary operations, the U.S. corporate venturer must be mindful of the host country's tax treatment of the partnership. In South Africa, joint ventures are invariably structured as partnerships.[535] The key advantage of operating a 50/50 joint venture in South Africa is that the venture is able to borrow from local sources up to 100 per cent of total shareholder's equity in the venture.[536]

Because the partnership is a pass through entity, the U.S. corporate partner may directly allocate its share of the partnership's interest expense to U.S source income.[537] If the U.S. parent owns at least 10% of a foreign corporate joint venture and receives repatriated profits from the venture, it may credit foreign income taxes paid by the venture.[538]

Under § 901 deemed foreign tax credits, the U.S. corporate partner is permitted to claim a distributive share of the joint venture's paid foreign taxes.[539]

Because the U.S. parent owns at least 10% of the partnership interest, its proportionate share of JVP's interest expense is added to the group's interest expense and the U.S. parent's foreign asset base 'includes the gross value of its share of JVP assets, not the value of its equity in JVP.[540] 'the benefit for a parent with excess credits is that a potion of its JVP interest expense reduces South African taxes and reduces US source income for U.S. tax purpose.

Nevertheless a few nontax obstacles may impede the use of this entity choice. In terms of canvassing for local partners, the staggered removal of sanctions in effect delayed the entry of U.S. MNCs and thus many South African companies willing to

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534 Deloitte, Touche, Tohmatsu, *supra* note 95, at 63.

535 Eisenberg,*supra* note 51, at 19.

536 Treas. Reg. 1.8619T(e)(7)(i).

537 Davis & Lainoff, *supra* note 105.

538 I.R.C. § 702(a)(6); Treas. Reg. 1.7021(a)(6).

539 Parnes, *supra* note 111, at 16; Treas. Reg. § 1.8619T(e)(2).

540 Just as several American corporations tried to demonstrate their commitment to social reforms by establishing education and training programs, trust funds, and other services for black South Africans during the height of the divestment movement, so too may the same companies now glean favorable 'corporate responsibility' marks by investing in the future of a majorityruled South Africa.

enter into joint venture may have already made committed with other MNCs. U.S. corporations may also face disadvantages in negotiating joint ventures in South Africa, as the local part may be unwilling to negotiate a structure in which the U.S. parent can achieve partnership status for the joint venture. Although having the venture treated as a partnership for U.S. tax purposes, the requirements necessary to achieve such status may require the South Africa counterpart to make concessions it otherwise does not consider in negotiating a venture with other foreign corporations. For example, in order for the joint venture to obtain partnership status, the South African venturer must agree to a specific distributions of assets. Added to these factors are social pressures for specific management features within the joint venture,[541] features that European and Asian corporation are unlikely to insist on in negotiating with local South African companies.

On balance, however, joint ventures appear to be offer the best avenue for most American corporations wishing to return to the South African marketplace.

To begin with, no deferral is possible and the U.S. parent must include currently the earnings of the venture. Since South Africa imposes a rate five percentage points higher than 35% all of the earnings will be sheltered by the foreign tax credit,[542] the loss of deferral provisions as a consequence of operating as a partnership poses no hardship on MNCs which are in a position of excess credits.

Secondly, JVP will be, under South African law, able to borrow up to 100% of its foreign assets because the South African equity interest equals 50%. Two favorable financing options are then available under this entity. If JVP borrows from a third-party lender, and the U.S. Parent holds more than 10% of JVP, US Parent must apportion its share of JVP's interest expense to all of its assets including the pro rata share of JVP's assets.[543] Just as a portion of domestic third-party loans attaches to foreign source income, so must a portion of foreign third-party loans *from a qualified partnership interest* proportionately attach to domesticsource income. This rule departs from the

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541 Davis & Lainoff, *supra* note 105.

542 Treas. Reg. § 1.8619T(f).

543 I.R.C. §§ 702(a),(b); 901(b)(5).

water's edge fungibility concept which as noted excludes the interest expense of nonU.S. entities. Here however the partnership is a passthrough entity and thus the interest expense apportionment to domestic source income affords at least a moderate tax benefit to U.S. Parent.

Thirdly, under § 901 deemed credit rules, US Parent is considered to have incurred a proportionate share of JVP's foreign taxes.[544] Having to meet a 10% threshold for foreign tax credit purposes, U.S. Parent looks through the partnership to determine which § 904 basket covers its share of partnership income.[545] This requires assessment of whether any of the following apply:[546] the high tax kickout exception[547] high withholding tax interest[548]

Conclusions

The relative incompatibility between the U.S. interest expense rules and South Africa regulations of foreign investments represents a difficult dilemma for U.S. manufacturing MNCs interested in tapping into South Africa's expanding markets. This dilemma lies in part from the new scheme of interest expense allocation among related corporations. Now U.S. parents should place as much of the interest expense associated with international investments unto their foreign affiliates.

However, South African currency regulations and tax laws encourage foreign companies to finance their own activities there. These regulatory features compound market-borne disadvantages that have arose from the scope and duration of the federal sanctions and current market conditions.

Although the corporate return to South Africa unfolds under truly unique circumstances, the incongruity of the U.S. tax law with the local regulatory environment in South Africa should not be construed as an anomalous situation. For it is the inflexibility of the new interest expense that prevent U.S.

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544 Treas. Reg. § 1.9045(h)(1).

545 Davis & Lainoff, *supra* note 105.

546 I.R.C. § 904(d)(2)(A)(iii)

547 I.R.C. § 904(d)(1)(B); *see* note 5 and accompanying text, *supra*.

548 That American multinational corporations may now experience difficulty in financing their South Africa businesses by no means overshadows the remarkable political metamorphosis South Africa has undergone in searching for ways to redirect its tragic and embittered history towards a more egalitarian future.

MNCs from obtaining a full deduction on general business interest expense. As a result, the type of foreign tax credit benefits that be procured in a given set of financing structure stands as a central feature of tax planning. When regulations or policies in the host country conflict with the preferred structures, additional tax costs enter into the decisional calculus. In that respect, the 'global tax disadvantage' these rules place on U.S. MNCs looms larger than what might have been anticipated when TRA 1986 was first contemplated.

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