NEW YORK STATE BAR ASSOCIATION TAX SECTION

Report on Proposed Section 901 Regulations Relating to Compulsory Payments of Foreign Taxes

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Report No. 1135

NEW YORK STATE BAR ASSOCIATION TAX SECTION

Report on Proposed Section 901 Regulations Relating to Compulsory Payments of Foreign Taxes

I. INTRODUCTION

This report sets forth the views of the New York State Bar Association Tax Section[1] on proposed amendments to Treas. Reg. § 1.901-2(e)(5) (the "proposed regulations"),[2] which provides that an amount paid to a foreign government is not a compulsory payment, and therefore is not treated as an amount of foreign tax paid for purposes of the foreign tax credit provisions, if it exceeds the amount of liability for tax under foreign law.

Under Treas. Reg. § 1.901-2(a)(2)(i), a foreign levy is a tax for purposes of the foreign tax credit rules only if it is a "compulsory payment." Treas. Reg. § 1.901-2(e)(5)(i) provides as follows:

> "(i) ***In general.*** – An amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax. An amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and

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1. This report was prepared by the Tax Section's Committees on "Inbound" U.S. Activities of Foreign Taxpayers and "Outbound" Foreign Activities of U.S. Taxpayers. The principal draftperson was Andrew H. Braiterman, with substantial contributions from Peter Connors, Edward Gonzalez, and Douglas McFadyen. Helpful comments were received from Kimberly Blanchard, Patrick Gallagher, Edward Gonzalez, David Hardy, David Hariton, David Miller, Erika Nijenhuis, Yaron Z. Reich, Michael L. Schler, and Diana L. Wollman. The assistance of Damon G. Rowe and Meredith M. Stead is gratefully acknowledged.

2. REG-156779-06, 72 Fed. Reg. 15081 (Mar. 30, 2007).

> application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment). Where foreign tax law includes options or elections whereby a taxpayer's tax liability may be shifted, in whole or part, to a different year or years, the taxpayer's use or failure to use such options or elections does not result in a payment in excess of the taxpayer's liability for foreign tax. An interpretation or application of foreign law is not reasonable if there is actual notice or constructive notice (*e.g.,* a published court decision) to the taxpayer that the interpretation or application is likely to be erroneous. In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts. A remedy is effective and practical only if the cost thereof (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success. A settlement by a taxpayer of two or more issues will be evaluated on an overall basis, not on an issue-by-issue basis, in determining whether an amount is a compulsory amount. A taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax."

The focus of the current rule is on addressing the "moral hazard" issue by denying credits for foreign tax payments that exceed the amount of tax actually required to be paid under foreign law. Without this rule, taxpayers could voluntarily pay more foreign taxes than they are required to pay and shift the economic burden to the U.S. government through the foreign tax credit. However, the current regulations do not require taxpayers to arrange their business activities in a way that minimizes foreign tax liabilities.

The proposed regulations would not change Treas. Reg. § 1.901-2(e)(5)(i) but would provide two sets of new rules that interpret and expand the current compulsory payment rules. The first set of rules would treat certain related U.S.-owned foreign entities as a single entity for purposes of determining whether foreign tax payments are

compulsory. The primary application of these rules would be to situations where one entity surrenders a loss or other foreign tax attribute to a related entity pursuant to a group relief or similar regime, and thereby reduces the liability of the related entity but potentially increases the liability of the surrendering entity in a future year. If the two entities are viewed as a single taxpayer, the loss surrender is consistent with the requirement that the taxpayer take reasonable steps to reduce its foreign tax liability over time. The second set of rules addresses "structured passive investment arrangements" ("SPIAs").[3] Under these rules, payments of foreign taxes in connection with certain arrangements that meet six specified conditions, which generally involve passive investment assets, financing transactions involving unrelated foreign counterparties, and arbitrage benefits derived from inconsistencies between U.S. and foreign tax law, are not treated as compulsory payments, thus resulting in denial of foreign tax credits.

II. SUMMARY OF RECOMMENDATIONS

A. U.S.-Owned Foreign Groups

1. We believe that the proposed regulations are helpful insofar as they clarify that, in the case of certain 80 percent-owned groups of foreign entities, a surrender of losses or other tax attributes from one entity to another entity will not result in future foreign taxes being treated as noncompulsory and therefore non-creditable. However, we question the proposed regulations' approach of limiting this rule to situations in which the 80 percent affiliation test is met and their failure to provide guidance with respect to circumstances in which the narrow affiliation test is not met. We recommend instead that

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3. Prop. Treas. Reg. § 1.901-2(e)(5)(iv).

the regulations be amended to state that group relief and similar elections do not violate the compulsory payment rule except in narrowly defined situations that have the potential for abuse. Alternatively, rules analogous to those provided in current and proposed regulations with respect to foreign combined returns could be made applicable in the context of group relief.

2. If our recommended approach described above is not adopted, we believe that the 80 percent test should be liberalized. In particular, we do not see any reason for the requirement that a single U.S. person must directly or indirectly own an 80 percent or greater interest in each of the foreign entities. In addition, we believe that straight preferred stock described in Section 1504(a)(4)[4] should be ignored for purposes of the 80 percent test.

B. Structured Passive Investment Arrangements

1. We approve of the general approach of the proposed regulations, which apply essentially objective tests for purposes of identifying transactions with respect to which foreign tax credits should be disallowed rather than relying on more subjective economic substance or business purpose tests. Although this approach entails an inevitable danger of underinclusiveness or overinclusiveness, we believe that the relative certainty of bright-line tests is beneficial both to taxpayers and to the government.

2. We also think that the proposed regulations' approach of treating passive investment activities differently from active business activities is appropriate.

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4. Except as otherwise specified, all "Section" references herein are to sections of the Internal Revenue Code of 1986, as amended.

3. We believe that the six conditions for SPIA treatment are in need of substantial refinement. In particular, we think that (i) the definition of passive investment income raises a number of issues, (ii) the direct investment test (which is intended to compare the foreign taxes paid in connection with the arrangement being tested with the taxes that would have been owed if the U.S. taxpayer directly owned the underlying assets) should be clarified, and (iii) the tests intended to identify inappropriate arbitrage benefits are too broad in some respects and too narrow in others.

4. The rule that denies all the otherwise allowable foreign tax credits attributable to an SPIA, as opposed to only credits with respect to foreign taxes that would otherwise result in duplicative benefits under U.S. and foreign tax law, is overly harsh and goes further than necessary to enforce the policies underlying the SPIA rules.

5. The proposed regulations should be amended to clarify that a deduction is available for foreign tax payments that are not creditable as a result of the SPIA rules.

C. <u>Effective Dates</u>

1. The proposed regulations would be effective for foreign taxes paid or accrued during taxable years ending on or after the date on which the regulations are published as final regulations. We think that this would result in an inappropriate degree of retroactivity, especially if the regulations are finalized prior to the end of 2007. We recommend that the regulations apply only to foreign taxes paid or accrued during taxable years beginning on or after the date the regulations are finalized.

2. The proposed regulations should be amended to clarify that the effective date is determined by reference to the taxable year of the entity that is liable for

the foreign taxes (*e.g.*, the U.S. taxpayer's foreign subsidiary where the U.S. taxpayer is claiming a Section 902 credit) in which the foreign tax is paid or accrued (based on the method of accounting used by the entity for foreign tax credit purposes), as opposed to the U.S. taxpayer's taxable year in which the credit is claimed.

III. U.S.-OWNED FOREIGN GROUPS

A. Overview of Provision

The current regulations do not provide any specific guidance as to whether the surrender of losses or foreign tax attributes to reduce the foreign tax liability of another entity potentially results in future taxes incurred by the first entity being treated as noncompulsory and therefore non-creditable. This issue can be illustrated by the following example:

> *Example 1*: A U.S. corporation ("USP") owns 100 percent of the stock of a Country X corporation ("FP"), which in turn owns 80 percent of the stock of another Country X corporation ("FS"). The remaining 20 percent interest in FS is owned by an unrelated foreign party. Country X has a 40 percent tax rate. In Year 1, FP has a $1,000 loss and FS has $1,100 in income. Pursuant to the Country X group relief regime, FP surrenders its loss to FS, reducing FS's Country X tax liability to $40. In Year 2, FP has $1,000 in income and incurs a $400 Country X tax liability. FP could have carried forward its Year 1 loss to Year 2 to eliminate its Year 2 tax liability if it had not surrendered the loss to FS.

Example 1 raises the question of whether the Country X tax liability incurred by FP in Year 2 is compulsory. The surrender of the loss not only increases FP's Year 2 foreign tax liability but also, subject to potential application of the compulsory payment

rule, increases the total foreign tax credits available to USP if all the earnings of FP and FS for the two-year period are distributed.[5]

The proposed regulations provide that a "U.S.-owned group" will be treated as a single taxpayer for purposes of Treas. Reg. § 1.901-2(e)(5).[6] For this purpose, the proposed regulations define a "U.S.-owned group" as any group consisting of two or more foreign corporations or other foreign entities where 80 percent or more of the stock (by vote and value) of the foreign corporations (or, in the case of non-corporate foreign entities, an interest in 80 percent or more of the income of the foreign entities) is owned, directly or indirectly, by a single U.S. person.[7] As a practical matter, this rule (the "deeming rule") is most likely to have meaningful application where, as in Example 1, a member of a U.S.-owned group (the "Transferor Member") surrenders, or otherwise transfers, a loss or other foreign tax attribute to another member of the group (the "Transferee Member"). In that situation, the proposed regulations provide that any foreign tax paid by the Transferor Member in a different taxable year will not be treated as noncompulsory merely because it would not have been payable had the Transferor Member carried over the loss and used it to reduce its taxable income in such year, rather than surrendering it to the Transferee Member.[8] The proposed regulations would also

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5. Because of the loss surrender, total foreign taxes deemed paid by USP are increased from $352 (80 percent of $440 in FS tax liability) to $432 ($400 in FP tax liability plus 80% of $40 in FS tax liability) because foreign tax liability is shifted from FS (which is an indirect 80 percent subsidiary of USP) to USP's wholly-owned subsidiary, FP.

6. Prop. Treas. Reg. § 1.901-2(e)(5)(iii)(A).

7. All domestic corporations that are members of a consolidated group are treated as a single U.S. person for this purpose. Prop. Treas. Reg. § 1.901-2(e)(5)(iii)(B).

8. Prop. Treas. Reg. § 1.901-2(e)(5)(iii)(C) *Example 1*.

treat members of a U.S.-owned group as a single entity for purposes of evaluating a settlement of a foreign tax dispute involving multiple issues and different members of the group.

The proposed regulations do not provide any explicit rule as to the effect of loss surrenders outside the context of a U.S.-owned group (as defined in the proposed regulations). For example, if FP in Example 1 owned only 51 percent of FS and that were sufficient to permit group relief, it is unclear under the proposed regulations whether the Year 2 tax paid by FP would be viewed as compulsory. The proposed regulations do, however, include one example in which a surrender of losses appears to result in foreign tax payments being noncompulsory:

> *Example 2:* A foreign corporation ("M") is treated as 99 percent owned by a U.S. corporation ("O") for U.S. tax purposes but for foreign tax purposes is treated as 100 percent owned by a foreign corporation ("L") that is unrelated to the U.S. corporation. M incurs a $10 million loss that it elects to surrender to L, which has $15 million in income, rather than to another corporation ("N") which is wholly-owned by M for U.S. and foreign tax purposes and has $25 million in income for the year in question.

The proposed regulations provide that M and N, but not L, are treated as a single taxpayer, and that the surrender of M's loss to L is not considered to reduce M's and N's collective foreign tax liability.[9] The proposed regulations strongly imply (but do not expressly state) that any subsequent year's tax liability imposed on M that would not have been incurred absent the loss surrender (or possibly a portion of N's liability in the year of the surrender) is not compulsory.

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9. Prop. Treas. Reg. § 1.901-2(e)(5)(iii)(C) *Example 2*.

B. Comments on Proposed Regulations

1. Recommended Approach

While additional guidance with respect to the application of Treas. Reg. § 1.901-2(e)(5) in the foreign group relief regime context is welcome, it is unclear whether the proposed regulations are intended to liberalize the compulsory payment regulations in the group relief context or to make them more restrictive.[10] Although the only explicit rule in this portion of the proposed regulations sets forth circumstances in which foreign tax payments will not fail to be treated as compulsory, the adoption of the deeming rule will have the effect of creating an implication, in those situations where the deeming rule does not apply, that the surrender of a loss by one member of a foreign group to another member potentially renders at least a portion of any foreign income tax subsequently paid by the transferor noncompulsory (and therefore non-creditable). As a result, given the fairly narrow scope of the deeming rule, the proposed regulations arguably increase rather than decrease the amount of uncertainty that currently exists with respect to the surrender of losses under foreign law group relief regimes.

By merely deeming a U.S.-owned group to be a single taxpayer for purposes of Treas. Reg. § 1.901-2(e)(5), the proposed regulations avoid the essential question of whether the surrender of losses pursuant to a foreign group relief regime in fact renders future taxes paid by the transferor noncompulsory within the meaning of Treas. Reg. § 1.901-2(e)(5). Rather than promulgating what is, in effect, a narrow safe harbor rule,

10. The notice of proposed rulemaking states that commentators have "raised questions" and "expressed concerns," but does not say anything about the government's view as to how these issues are treated under current law.

we believe that the government should, instead, provide broader guidance with respect to the consequences associated with the surrender or transfer of losses generally. In that regard, if the government thinks that there are circumstances in which taxes paid by a foreign corporation should be treated as noncompulsory under Treas. Reg. § 1.901-2(e)(5) merely because the corporation had previously surrendered losses pursuant to a foreign group relief regime – treatment that we do not think is generally mandated by the existing rules or necessarily appropriate as a policy matter – we recommend that the regulations expressly provide for that result.

In our view, a broad rule providing that loss surrenders result in future taxes being noncompulsory is unwarranted on several grounds. To begin with, we do not believe that, by itself, the ability to surrender losses pursuant to a foreign group relief regime gives rise to the same potential for abuse as, for example, the type of arbitrage arrangements that come within the ambit of the proposed rules addressing SPIAs. Rather, we believe that, in most instances, the decision to surrender losses under a foreign group relief regime is driven by factors unrelated to the maximization of U.S. foreign tax credits. Where a foreign parent corporation surrenders a loss to a less than wholly-owned subsidiary it implicitly gives up a portion of the value of that loss. In doing so, however, it presumably has determined that there is a benefit associated with the current, as opposed to future, utilization of the loss and that, in economic terms, the value to it of that benefit, even taking into account the fact that it is shared with the other owners of the

subsidiary, is greater than the value of any future tax deduction associated with a carryforward of the loss.[11]

Accordingly, we believe that a better approach would be to provide that the surrender of losses pursuant to a foreign group relief regime does not have any negative implications with respect to the creditability of future foreign taxes absent specific factors that are indicative of tax avoidance. In this regard, we believe, for example, that it is appropriate that the surrender of losses in the situation described in Example 2 of Prop. Treas. Reg. § 1.901-2(e)(5)(iii)(C) (summarized above) should result in at least a portion of any future foreign taxes paid by the transferor (*i.e.*, M) being treated as noncompulsory. That position is, however, predicated not on the fact that the transferor and the transferee (*i.e.*, L) are different taxpayers but, rather, on the existence of a number of factors, in particular the difference between the ownership of the transferor under U.S. and foreign tax principles, that are indicative of potential tax avoidance. These factors include differences between ownership rules under U.S. and foreign tax law, the absence of any U.S. ownership of the company to which the losses are surrendered, and the fact that the loss company had a choice as to which company to surrender the loss to and opted for the company which, for U.S. tax purposes, had no U.S. ownership. Our difficulty with the example in the proposed regulations is the failure to specify which of these factors is determinative and the lack of guidance with respect to situations in which not all of these factors are present.

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11. It is possible, of course, that, as an economic matter, the parent will receive the full benefit of the loss as a result of a payment by the subsidiary to the parent.

Consistent with the foregoing, in our view, a better approach to situations such as that illustrated in Example 2 would be to specify that a surrender of tax attributes results in future foreign tax paid by the transferor being noncompulsory if and only if three specific conditions are met. The first condition would be that the transferor's direct or indirect percentage equity ownership in the transferee (or, as appropriate, the transferee's percentage equity ownership in the transferor, or the direct or indirect percentage equity ownership of a common parent in the transferor and/or the transferee) is characterized differently for U.S. and foreign tax purposes. The second condition would be that the surrender is part of an overall arrangement a principal purpose of which is to provide a foreign tax benefit to the transferee and to enable the transferor's direct or indirect U.S. shareholders to claim an increased foreign tax credit. The third condition is that the present value of the foreign tax credits that can reasonably be expected to be claimed by U.S. persons under Section 901 in connection with the foreign tax paid by the members of the foreign group is greater than the present value of credits that could reasonably have been expected to be claimed absent the surrender.

If Treasury and the IRS do not believe that it is appropriate to adopt our primary recommendation of freely permitting the surrender of tax attributes under group relief regimes absent specific circumstances indicative of abuse, we believe that Treasury and the IRS should consider more closely aligning the results that arise in the foreign group relief context with those that arise under Treas. Reg. § 1.901-2(f) in the foreign consolidated group context.[12] Under a typical foreign consolidated tax regime, losses

12. These rules would be modified as part of the proposed amendments to the technical taxpayer rules. REG-124152-06, 71 Fed. Reg. 44240 (Aug. 3, 2006).

realized by a member of the consolidated group are, in effect, transferred to those members of the group with current income. The use of those losses by other members of the group does not appear, however, to result in any future taxes paid with respect to income of the loss member being considered as noncompulsory within the meaning of Treas. Reg. § 1.901-2(e)(5), at least in situations where consolidation is required under foreign tax law.[13] That stands in stark contrast to the result that, in light of the proposed regulations, arguably obtains in the foreign group relief context. To our mind, foreign group relief and foreign tax consolidation regimes are merely alternative methods of implementing the same basic policy objectives. Although consolidation regimes typically lack the element of electivity that is inherent in the group relief regime context, we question whether that difference, on its own, is sufficient to justify the significant disparity in result that is suggested by the proposed regulations. With that in mind, one option that the government might consider is to treat a foreign corporation's surrender of losses pursuant to a foreign group relief regime as irrelevant for purposes of Treas. Reg. § 1.901-2(e)(5) except to the extent that the amount of foreign taxes that could ultimately be claimed as credits exceeds the amount of credits that would have been available if the principles of Treas. Reg. § 1.901-2(f) applicable to consolidated return regimes were applied to the foreign group of which the foreign corporation is a member.[14]

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13. It is possible, however, that the IRS could argue that filing consolidated returns when it is not mandatory to do so creates an issue under the compulsory payment rules.

14. The amount of potential credits could be higher under a group relief regime because of the ability to select the profitable affiliate to which losses are surrendered in a manner that maximizes foreign tax credits. In contrast, under a consolidated return regime, losses incurred by one member generally are deemed to reduce foreign taxes payable by affiliates with positive income on a pro rata basis.

More generally, where a corporation surrenders a loss to a subsidiary, the subsidiary's use of the loss reduces its liability for foreign tax and thus the amount of foreign tax that will ultimately be deemed to be paid by its U.S. shareholders. Given that, to the extent that the surrender of a loss results in a portion of any future tax paid by the transferor being considered to be noncompulsory, the proposed regulations should be clarified to provide that the noncompulsory payment is limited to that portion of such future tax in excess of the U.S. taxpayer's pro rata share of the tax that would have been payable by the transferee in the absence of the surrender of the loss.

2. Technical Comments

On a more technical level, to the extent that the IRS and Treasury choose to retain the basic approach of the proposed regulations, we suggest that they reconsider the relevance and appropriateness of certain of the requirements for falling within the scope of the deeming rule. To begin with, it is unclear why the percentage of U.S. ownership in a foreign corporation – and whether or not that ownership is represented by one or more U.S. persons – should have any relevance in determining whether the corporation and its subsidiaries should be treated as a single taxpayer for purposes of Treas. Reg. § 1.901-2(e)(5). Rather, at least as a conceptual matter, whether a foreign corporation in which a U.S. person holds an interest and one or more of the corporation's foreign subsidiaries should be treated as a single taxpayer for U.S. foreign tax credit purposes would seem to depend solely on the level of overlapping share ownership between or among the foreign corporations. Specifically, where a foreign parent transfers a loss to a wholly-owned subsidiary, the transfer as a general matter should have no effect on the ultimate amount of foreign taxes available for credit by the parent's U.S. shareholders. Given that, it is

unclear to us why a U.S. corporation should be denied the benefit of the safe harbor merely because it owns less than 80 percent of the stock of the particular foreign corporation. For example, contrast Example 1 above, in which $432 in foreign taxes would ultimately be creditable to USP, with the result that potentially would occur under the proposed regulations if FS were a wholly-owned subsidiary of FP but FP were owned equally by two U.S. corporations. In that scenario, FP and FS would not constitute a U.S.-owned group and, thus, the foreign tax paid by FP in the post-loss taxable year potentially would be regarded as noncompulsory. That is true notwithstanding that the total amount of foreign taxes available for credit under Section 901 would be the same regardless of whether FP surrendered the loss (in contrast to Example 1, where the amount of the foreign tax credit potentially available to USP, $432, is $80 higher than it would have been had FP not surrendered its loss). Thus, the proposed regulations appear to penalize taxpayers only in what might reasonably be described as the less abusive of the two scenarios.

Quite apart from the practical operation of the proposed regulations from a fiscal perspective, providing more favorable treatment to a majority shareholder would seem to be questionable as a policy matter. Specifically, the case for penalizing a U.S. shareholder as a result of a transfer of a foreign loss would seem to be much stronger where the U.S. shareholder actually has the ability to control the allocation. By contrast, the proposed regulations potentially protect taxpayers in situations where the transfer is in fact made at the direction of the U.S. shareholder, while penalizing taxpayers in situations where the taxpayer has no control over whether or not the loss is surrendered or carried forward.

We acknowledge that there are arguments for requiring direct or indirect U.S. ownership (albeit not by a single U.S. person) of both the transferor and the transferee. For example, if a foreign parent corporation with no U.S. shareholders owns a controlling interest in a foreign subsidiary with a minority U.S. shareholder, the subsidiary could surrender losses to the parent to reduce liability for foreign taxes that if paid could not have been claimed as a credit by a U.S. taxpayer while potentially increasing future foreign taxes that could be claimed as a credit. Such a situation poses issues similar to Example 2. However, we do not believe that there should be a special rule applicable to such "upstream" loss surrenders. As a practical matter, a minority U.S. shareholder of the subsidiary is unlikely to be in a position to control the relevant foreign tax decisions. In addition, in situations where the U.S. minority shareholder potentially would be entitled to foreign tax credits for a substantial portion of the taxes paid by the foreign subsidiary (which is likely to occur only when the U.S. shareholder owns preferred stock), it is probably unlikely that the subsidiary will have substantial losses to surrender. In any event, the rules applicable to groups filing consolidated foreign returns impose no restrictions on this type of loss utilization.

Another questionable aspect of the proposed regulations is the use of the 80 percent ownership test. We do not believe it is appropriate to apply a U.S. affiliation test in situations where foreign group relief regimes require a lower (but still substantial) level of common ownership. In addition, it is anomalous that, while generally adopting U.S. affiliation principles, the proposed regulations require "plain vanilla" preferred stock described in Section 1504(a)(4) to be taken into account and therefore impose a stricter affiliation test than the test applicable for purposes of eligibility to file U.S. returns.

Concededly, foreign taxes attributable to income of a foreign subsidiary that is paid out as dividends to unrelated preferred shareholders would not be available as credits to a direct or indirect U.S. holder of the common stock. However, the economic burden of foreign taxes generally is borne by the common shareholders, and we do not believe that straight preferred stock should be taken into account in determining whether there is sufficient identity of economic interest to justify deeming two related entities to be a single taxpayer.

In addition, the proposed regulations apply the deeming rule only to foreign corporations and other foreign entities. It is unclear whether "foreign entities" for this purpose include U.S.-owned hybrid entities organized under foreign law that are treated as disregarded entities for U.S. tax purposes. We believe that it is appropriate to apply the "deeming" rule to hybrid entities as well as to U.S. entities with branch operations that may be entitled to surrender losses to affiliates (or have losses surrendered to them by affiliates) under foreign tax rules.

Finally, it has been suggested that, by treating a U.S.-owned group as a single taxpayer, the proposed regulations could have the practical effect in some circumstances of forcing the surrender of losses (with potentially adverse consequences under the dual consolidated loss rules or otherwise) in order to minimize the foreign tax liability of the transferee. Treas. Reg. § 1.901-2(e)(5)(i) provides that the failure to make an election whereby a taxpayer's tax liability may be shifted to a different year does not necessarily result in the foreign tax paid by the taxpayer exceeding its legal liability for such taxes. On the basis of that rule, we believe that the better view is that the proposed regulations do not create an obligation on the part of a loss corporation to surrender its losses to

another member of a U.S.-owned group. Nonetheless, in light of the apparent uncertainty on this point, clarification would be helpful.

IV. CERTAIN STRUCTURED PASSIVE INVESTMENT ARRANGEMENTS

A. Background to Proposed Regulations

The preamble to the proposed regulations (the "Preamble") states that "[t]he IRS and Treasury have become aware that certain U.S. taxpayers are engaging in highly structured transactions with foreign counterparties to generate foreign tax credits."[15] These transactions, in the government's view, are designed to utilize foreign special purpose vehicles ("SPVs") to effect what otherwise would be ordinary financing activities or portfolio investments in order to generate foreign tax liabilities that would not normally be imposed on the underlying business activities. These transactions are structured in a manner intended to permit U.S. taxpayers to claim foreign tax credits while also creating foreign tax benefits for foreign counterparties as a result of inconsistencies between U.S. and foreign tax laws.

The notice identifies three broad categories of transactions that raise this concern. The first category consists of "U.S. borrower" transactions, in which the U.S. taxpayer owns an equity interest and the foreign counterparty advances funds to the U.S. taxpayer or the SPV in a manner that constitutes a loan for U.S. tax purposes and equity ownership of the SPV for foreign tax purposes. The U.S. taxpayer claims a foreign tax credit for taxes paid by the SPV while the foreign taxpayer derives a benefit such as a participation exemption or a foreign tax credit in its home jurisdiction. The benefit derived by the

15. Preamble, ¶ B.

foreign counterparty results in its being willing to accept a lower pre-tax yield than it would require on an ordinary loan.

The second type of transaction is a "U.S. lender transaction" in which a U.S. taxpayer advances funds to a foreign borrower indirectly through an SPV. The U.S. party claims a foreign tax credit for the taxes paid by the SPV while the foreign counterparty deducts interest paid or accrued to the SPV and benefits from "cheap financing" resulting from the U.S. taxpayer's ability to claim foreign tax credits.

The third category of transactions is an "asset holding" transaction in which a U.S. person owns income-producing portfolio investments through an SPV. A foreign counterparty participates in the arrangement, in a manner that results in a foreign tax benefit, in exchange for sharing a portion of the economic cost of the SPV's foreign taxes for which the U.S. person claims a credit.

The IRS and Treasury believe that the intended consequences of these transactions are inconsistent with the foreign tax credit's purpose of mitigating double taxation. In the government's view, the ability to claim foreign tax credits with respect to these types of transactions creates an inappropriate incentive for the U.S. taxpayer to voluntarily subject itself to foreign taxes; both the U.S. taxpayer and the foreign counterparty derive tax benefits, the foreign jurisdiction receives increased tax payments, and the U.S. government bears the burden of reduced tax revenues.

B. Overview of Proposed SPIA Rules

The proposed regulations provide a set of mostly bright-line rules for identifying certain types of transactions that are intended to generate foreign tax credits in a manner that Treasury and the IRS consider to be abusive. The approach of the proposed

regulations does not entail an explicit inquiry into whether a transaction has economic substance or a non-tax profit motive or is otherwise inconsistent with the purpose of the foreign tax credit. Instead, Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(A) would deny credits for foreign taxes[16] paid that are "attributable to an arrangement" that meets six conditions specified in Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(B). These conditions, which are discussed in more detail at IV.D, below, can be summarized as follows:

> (i) Special purpose vehicle: The arrangement involves an entity (a) substantially all of the income of which is passive investment income and substantially all the assets of which are held to produce passive investment income and (b) which generates income with respect to which foreign taxes are paid.[17]
>
> (ii) *U.S. party*: A U.S. person would be eligible to claim a foreign tax credit with respect to foreign taxes paid with respect to the SPV's income.[18]
>
> (iii) *Direct investment*: The foreign taxes paid are substantially greater than the amount that would have been creditable by the U.S. party if it directly owned its proportionate share of the SPV's assets.[19]
>
> (iv) *Foreign tax benefit*: The arrangement results in a foreign tax benefit to a counterparty described in (v) below.[20]
>
> (v) *Unrelated counterparty*: The arrangement involves a foreign counterparty unrelated to the U.S. taxpayer that, for foreign tax purposes, is treated as directly or indirectly owning at least 10% of the equity of the SPV or as acquiring at least 20% of the value of the assets of the SPV.[21]

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16. Although the proposed regulations state that an amount for which credits would be denied is "not an amount of tax paid," such amounts are taxes within the normal sense of the word and are referred to as such in this report.

17. Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(B)(*1*).

18. Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(B)(*2*).

19. Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(B)(*3*).

20. Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(B)(*4*).

21. Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(B)(*5*).

(vi) *Inconsistent treatment*: U.S. and foreign tax law provide inconsistent treatment of certain aspects of the arrangement that materially affect the amount of income recognized or amount of foreign taxes otherwise creditable by the U.S. party.[22]

If all six conditions are satisfied, the proposed regulations would deny credits for all foreign taxes attributable to the arrangement; conversely, if one or more of the criteria is not met, no credits would be denied under the proposed regulations (the "All or Nothing Rule").[23] Under the All or Nothing Rule, the denial of credits is not limited to the foreign taxes attributable to the foreign counterparty's investment or otherwise related to the arbitrage aspect of the transaction.

C. Comments on General Approach of Proposed SPIA Rules

1. Use of Bright-Line Tests

We generally approve of the proposed regulations' approach of establishing specific criteria for disallowing foreign tax credits, as opposed to reliance on more nebulous "facts and circumstances," "business purpose," or "economic substance" tests.[24] The Preamble correctly rejects adoption of a broad anti-abuse rule on the ground that it "would create uncertainty for both taxpayers and the IRS."[25] Establishing a bright-line test, if it is properly defined, should effectively deter taxpayers from entering into abusive transactions and avoid the need for costly, time-consuming, and uncertain audit

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22. Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(B)(*6*).

23. The IRS could, however, attempt to deny credits on other grounds if appropriate.

24. In 1998, the IRS attempted to address foreign tax credit arbitrage transactions by applying an economic profit test and treating foreign taxes as an expense. Notice 98-5, 1998-1 C.B. 334. This attempt was widely criticized. *See, e.g.*, Peaslee, *Economic Substance Test Abused: Notice 98-5 and the Foreign Law Taxpayer Rule*, 79 TAX NOTES 79 (Apr. 6, 1998). Notice 98-5 was eventually withdrawn. Notice 2004-19, 2004-1 C.B. 606.

25. Preamble, ¶ B.3.

proceedings and litigation. We believe, however, that it would be helpful if the regulations themselves explicitly recite the underlying policy principles expressed in the Preamble.

Of course, if an objective, mechanical test is adopted, it is important that the criteria be defined in a manner such that denial of credits will not apply to normal business transactions as opposed to more contrived tax-motivated transactions involving passive assets that can easily be moved among different taxing jurisdictions. To avoid such overinclusion, however, the rules may need to err on the side of being too narrow and therefore not apply to at least some transactions that are primarily tax-motivated (and may in fact be similar in certain respects to SPIAs) and possibly should be prohibited.[26]

With respect to pre-effective date transactions, the Preamble states that "the IRS will continue to utilize all available tools under current law to challenge the U.S.

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26. For example, we understand that, under the U.K. tax rules governing repos entered into prior to October 1, 2007, a transaction denominated as a repo can qualify for the favorable treatment described below even if the purchaser of the shares has the unrestricted right to sell the shares, and in fact sells them. Some corporate U.K. taxpayers have taken advantage of these rules by entering into "broken repo" transactions, in which shares in a U.K. resident company are sold to a financial intermediary in the expectation that they will be resold immediately to an unrelated third party. The transactions are structured so that the intermediary has no risk in relation to continuing obligations to the seller (nominal obligations to return shares or to deliver consideration of equivalent value are matched and offset by entitlements to receive equivalent payments from the U.K. taxpayer), and derives a small fee. As a result of its entry into the broken repo, the U.K. taxpayer is not obligated to make, or entitled to receive, any net payments, and it has no continuing interest in the transferred shares. Nevertheless, the U.K. taxpayer is deemed for U.K. tax purposes to receive a "manufactured dividend" and to make a matching and offsetting interest payment. The benefits of the transaction stem from the disparate treatment of these two deemed payments: the manufactured dividend is tax-exempt, the deemed interest is tax-deductible, and there is no rule analogous to Section 265 to disallow deductions for costs incurred in earning tax-exempt income. If the ultimate purchaser of the shares is a U.S. taxpayer that is entitled to a credit for foreign taxes paid by the issuer of those shares, then there is a duplicative benefit similar to that produced by an SPIA. However, because the U.K. taxpayer that sold the shares is no longer treated as actually owning the shares or receiving dividend income for U.K. tax purposes – in some transactions a representation was obtained to that effect – it appears that SPIA treatment would not apply. We understand that, as a result of changes in U.K. tax law, where a corporate U.K. taxpayer enters into a repo on or after October 1, 2007, the U.K. taxpayer will be regarded as continuing to hold the shares and as not receiving "manufactured" dividends, and that amounts recorded in the financial accounts of the U.K. taxpayer as a financing charge will be treated as tax deductible interest.