Tax Report #924

New York State Bar Association

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March 25, 1998

Honorable Donald C. Lubick
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose a report prepared by an ad hoc committee of the Tax Section of the New York State Bar Association responding to the request in Notice 98-5, 1998-3 I.R.B. 1 (the "Notice"), for comments on regulations to be issued with respect to the availability of foreign tax credits in certain transactions.

The Notice identifies two classes of transactions that, in the view of the Treasury and the Internal Revenue Service, create a potential for abuse of the present foreign tax credit rules — an acquisition of an asset that generates an income stream subject to foreign withholding tax, and the effective duplication of tax benefits through the use of a structure that exploits inconsistencies between U.S. and foreign tax laws. According to the Notice, these transactions generally yield little or no economic profit

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in comparison to the expected U.S. tax benefits. The Notice promises regulations to address these transactions. The regulations would be effective for foreign income taxes paid or accrued on or after December 23, 1997.

The Notice illustrates what the regulations will provide with five examples. In each case, the expected economic profit, determined by treating the foreign income tax as an expense, is deemed to be insubstantial in comparison to the potential foreign tax credit. While the "basket" rules of Section 904(d) of the Code would otherwise allow the foreign income taxes to be credited against residual U.S. tax on other income in the same basket, the examples would allow no credit at all.

The principal comments and recommendations of the Report are summarized below.

1. The approach outlined in the Notice seems designed to change the "technical taxpayer" rule in the Section 901 regulations, at least where the expected economic profit is insubstantial. The Report questions whether a test based on insubstantiality of profit is (i) administrable by the Service or predictable by taxpayers, (ii) an appropriate test for determining whether a taxpayer has borne the burden of a foreign tax or (iii) a reliable indicator of abuse. If the intent is not to change the technical taxpayer rule, but rather to extend the Section 904(d) basket rules, the Report questions whether there is authority to do so by regulation.

2. With respect to the "cross-border tax arbitrage transactions" identified by the Notice, the Report recommends instead the issuance of regulations that deal generally with integrated tax systems and hybrid entities or transactions. These regulations could modify the technical taxpayer rule to provide that a Section 902 credit would not be available to a U.S. shareholder of a foreign corporation for foreign taxes that the foreign country regards as paid on the income of another shareholder.

3. With respect to the foreign withholding tax transactions identified by the Notice, the Report recommends that withholding taxes be allowed as a credit only to the extent that they are paid on income that has been accrued (i.e., earned) by the taxpayer. This might be limited to cases where ownership of the income stream does not meet a holding period requirement. Consistent with the Notice, the Report recommends that an accrual rule not apply to dividends covered by paragraph (1) or (2) of Section 901(k). Unlike the Notice, the Report also recommends the exclusion of dividends eligible for the exception of Section 901(k)(4), at least in the case of transactions in the ordinary course of business, and that

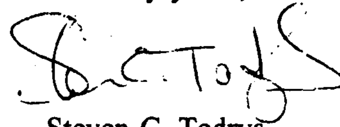
consideration also be given to a broader exclusion for ordinary course transactions of dealers and others who regularly buy and sell debt securities.

4. Whatever approach is adopted, the Report recommends that the normal regulatory process be followed. In other words, proposed regulations should be issued for comment and should not be effective prior to adoption. In particular, the Report comments that application of the Notice to taxes paid or accrued after December 23, 1997 (thus including income taxes imposed for all of 1997) is inappropriate given the late issuance of the Notice and the lack of clarity in the Notice on what constitutes an "abusive" transaction.

5. In the event that the approach outlined in the Notice is retained, the Report also provides specific comments on certain aspects of this approach, including coordination with Section 901(k); allowance of a deduction for foreign taxes where a credit is disallowed; the economic profit test; the definition of "arrangement"; the allocation of interest expense; and the need for examples of non-abusive transactions and a definition of substantiality.

Please let me know if we can be of further assistance in drafting these regulations.

Sincerely yours,



Steven C. Todrys
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(Enclosure)

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March 25, 1998

Report on Notice 98-5

This report, prepared by an ad hoc committee of the Tax Section of the New York State Bar Association,[1] addresses Notice 98-5, 1998-3 I.R.B. 1, released on December 23, 1997 (the "Notice"), and responds to the invitation in the Notice for comments on what might be included in regulations or other guidance to be issued with respect to the availability of foreign tax credits in certain transactions.

Summary of the Notice

The Notice responds to the perception of the Treasury and Internal Revenue Service that U.S. taxpayers have entered into "abusive tax-motivated transactions with a purpose of acquiring or generating foreign tax credits that can be used to shelter low-taxed foreign source income from residual U.S. tax". According to the Notice, these transactions "generally are structured to yield little or no economic profit" in comparison to the expected U.S. tax benefits. The result is an "abuse [of] the cross-crediting regime" that is "clearly incompatible with the existence of the detailed foreign tax credit provisions and cross-crediting limitations enacted by Congress".

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[1] Co-chaired by Emily S. McMahon and Willard B. Taylor and consisting of Peter Blessing, Mitra Forouhar, Michael Foley, Susan Grbic, Hilary Hoover, Stephen Land, Sara McLeod, Michael Miller, Alex Mostovi, John Narducci, James Peaslee, Kevin Rowe, Elissa Shendalman, Po Sit, Marc D. Teitelbaum and Louise Weingrod. Helpful comments were received from David Brockway, Samuel Dimon, Charles Kingson, Richard Loengard, Michael Schler, Robert Scarborough and Andrew Solomon.

The Notice identifies two classes of transactions that create a potential for foreign tax credit abuse — an acquisition of an asset that generates an income stream subject to foreign withholding taxes, and the "effective duplication" of tax benefits through the use of a structure that exploits inconsistencies between U.S. and foreign tax laws — and it promises regulations, as well as the application of other principles of existing law, to address these transactions. The regulations would be effective for foreign income taxes paid or accrued on or after December 23, 1997.

The Notice also indicates that Treasury and the Internal Revenue Service may issue other guidance that addresses "abusive" transactions involving high withholding tax interest, transactions that create a mismatch between the time of payment or accrual of foreign taxes and the time the related income is recognized for U.S. tax purposes, and foreign tax credits claimed with respect to transactions discussed in the Notice where the taxpayer has hedged its risk with respect to assets or income streams that produce the credit. These regulations will be effective no earlier than the date that proposed regulations are issued.

The Notice illustrates what the regulations will provide with five examples, three relating to acquisitions of assets that generate income streams subject to foreign withholding taxes and two relating to structures that exploit inconsistencies between U.S. and foreign tax laws. In each of the examples, the expected economic profit, determined by treating the foreign income tax as an expense, is deemed to be insubstantial in comparison to the foreign tax credit that would be claimed. There is no

illustration of a case in which the expected economic profit is not insubstantial and no other definition of "insubstantiality" apart from what may be inferred from the examples.

The results in the examples are harsh. While the "basket" rules of Section 904(d) of the Code would otherwise allow the foreign income taxes to be credited against residual U.S. tax on other income in the same basket, the examples would allow no credit at all. Thus, for instance, the taxpayer in Example (2) is not allowed a credit for even the foreign income tax imposed on its economic profit of $.15. In addition, no foreign tax credit is allowed to any other taxpayer involved, so that if in Example (2) the bond had been purchased from a U.S. taxpayer, that taxpayer would not be allowed a credit for the withholding tax attributable to the income which accrued prior to its sale. Although the Notice does not apply to dividends described in paragraphs (1) and (2) of new Section 901(k), its results may also frequently be harsher than would be the case under that section.[2/]

The Administration's 1999 budget proposals, released on February 2, 1998, include a provision that would give the Treasury Department authority to issue regulations with respect to "tax avoidance" through the use of hybrid entities and hybrid instruments, effective as of the date of enactment. Although the

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[2/] This will depend on the amount of the foreign withholding tax and the extent to which that tax is reflected in market prices - to the extent that the market does not treat the tax as a cost (i.e., assumes that it will be a credit), it is likely that the typical 15% withholding tax on dividends will make the expected profit on a fixed rate preferred stock insubstantial if the taxpayer only holds the stock for the 16 days before the ex-dividend date.

foreign tax credit is not the main focus of this proposal, the provision may provide a basis for the foreign tax credit regulations contemplated in the Notice — at least to the extent that the regulations address cross-border arbitrage transactions.[3]

Summary of Comments

In summary of what is set out at more length below, we have the following comments on the Notice:

1. Although the stated purpose of the Notice is to prevent "abuse", the approach seems designed instead to change the "technical taxpayer" rule in the Section 901 regulations, at least where the expected economic profit is insubstantial. We question whether a test that looks to insubstantiality of profit is (i) administrable by the Service or predictable by taxpayers, (ii) an appropriate or reliable test for determining whether a taxpayer has borne the burden of a foreign tax or (iii) a reliable indicator of abuse. If the intent is not to change the technical taxpayer rule, but rather to extend the Section 904(d) basket rules, we question whether there is authority to do so by regulations.

2. With respect to the "cross-border tax arbitrage transactions" identified by the Notice, we recommend instead the issuance of regulations that would deal generally with integrated tax systems and hybrid entities or transactions. These regulations

[3] Department of the Treasury, General Explanations of the Administration's Revenue Proposals, February 1998, at p. 144. See also, Staff of the Joint Committee on Taxation, Description of the Revenue Provisions Contained in the President's Fiscal Year 1999 Budget Proposals at pp. 196-197.

could, for example, modify the technical taxpayer rule to provide that a Section 902 credit would not be available to a U.S. shareholder of a foreign corporation for foreign taxes that the foreign country regards as paid on the income of another shareholder.

3. With respect to the foreign withholding tax transactions identified by the Notice, we recommend that withholding taxes be allowed as a credit only to the extent that they are paid on income that has been accrued (i.e., earned) by the taxpayer. This might be limited to cases where ownership of the income stream does not meet a holding period requirement. We also believe the principle underlying such a rule — that a credit should not be allowed for taxes paid on income earned by another person or built-in at the time the asset is acquired — goes beyond withholding taxes.

4. Consistent with the Notice, we would not apply such an accrual rule to dividends to which paragraph (1) or (2) of Section 901(k) applies. Unlike the Notice, we would also exclude dividends excepted from paragraphs (1) and (2) by Section 901(k)(4), at least in the case of transactions in the ordinary course of business, and we would seriously consider in such a case whether an accrual rule should apply at all to dealers and others who regularly buy and sell debt securities.

5. Whatever approach is adopted by the Internal Revenue Service and the Treasury, the normal regulatory process should be followed — in other words, proposed regulations should be issued for comment and should not be effective prior to adoption.

6. If the approach of the Notice is retained, we have specific comments on aspects of the Notice, including coordination with Section 901(k); allowance of a deduction for foreign taxes where a credit is disallowed; the economic profit test; the definition of "arrangement"; the allocation of interest expense; and the need for examples of non-abusive transactions and a definition of substantiality.

Background

The foreign tax credit is the basic means for eliminating the double taxation of foreign income. As the Notice correctly says, the foreign tax credit is not an incentive but is intended to eliminate the disincentives that would otherwise exist to foreign investment.

Originally enacted in 1918, the foreign tax credit has been repeatedly re-examined by Congress — every major tax act in the last two decades has included important revisions to the rules, including the Taxpayer Relief Act of 1997. Statutory limitations on the foreign tax credit rules include the basic limitation in Section 904(a), the basket rules of Section 904(d), the expense allocation rules of Section 864(e), and a number of more-targeted provisions, including rules which in the case of foreign oil and gas income disallow credits for foreign taxes imposed at rates that are regarded as too high.

The basket rules of Section 904(d), greatly expanded by the Tax Reform Act of 1986, prevent taxpayers from cross-crediting foreign taxes paid on income in one separate limitation category

against residual U.S. tax on lower-taxed foreign income included in another category. The separate limitation categories include the types of income that, in Congress' view, "frequently bear little foreign tax or abnormally high foreign tax, or are relatively manipulable as to source".[4] The ability to cross-credit foreign taxes with respect to these types of income (as was permitted, in many cases, under prior law) was thought to create too significant an incentive at the margin for taxpayers to make new investments abroad, rather than in the United States. Within the separate baskets, however, and within the general limitation category, cross-crediting of foreign taxes is permitted, reflecting Congress' belief that the averaging of foreign tax rates generally should continue to be allowed.[5] The only exception to this general rule is the "high-tax kickout" of Section 904(d)(2)(A)(iii)(III), a "mechanical rule" that moves high-taxed income from the passive basket into the general limitation basket in order to "ensure ... that substantial averaging within the passive basket is avoided".[6]

After several years of proposed, re-proposed and temporary regulations, the present regulations under Section 901 were adopted in 1983.[7] A major focus of these regulations was preventing perceived "abuses", particularly in the case of

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[4] Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (hereinafter the "1986 Blue Book"), at p. 863.

[5] Id. at p. 862.

[6] Id. at p. 880.

[7] T.D. 7918, 1983-2 C.B. 113. The process began in 1978 with the issuance of a notice requesting public comment on revisions to the regulations, 43 Fed. Reg. 38,429 (1978).

"subsidies" and so-called "dual capacity" taxpayers, and they superseded prior case law and rulings.[8] These regulations generally adopt the rule — the so-called "technical taxpayer" rule — that a foreign tax is considered paid (and is therefore creditable) by the person who is the taxpayer under foreign law.[9] This general rule is subject to rules that might be viewed as exceptions, including a rule that disallows credits for foreign income taxes used to provide subsidies. Although the treatment of foreign taxes paid to countries that have an "integrated" system of taxing corporate income has been an issue at least since Biddle,[10] any special rule for such taxes was "reserved" when the Section 901 regulations were adopted in 1983.[11] An earlier set of the temporary regulations would have provided that a payment of advance corporation tax that could be taken as a credit by shareholders under an integrated tax system was not a foreign income tax paid by the corporation.[12]

The Section 901 regulations were adopted at a time when hybrid entities were less common than they are today, and the

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[8] Nissho Iwai American Corp. v. Commissioner, 89 T.C. 765, 777 (1987); Texasgulf Inc. & Subsidiaries v. Commissioner, 107 T.C. 51, 68-69 (1996).

[9] Regs. § 1.901-2(f)(1) ("The person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person...remits such tax.")

[10] Biddle v. Commissioner, 302 U.S. 573 (1938).

[11] Regs. § 1.901-2(e)(4)(ii).

[12] Temp. Regs. § 4.901-2(f)(4)(iv) (November 12, 1980), reprinted in 1981-1 C.B. 396, 405. See also, the discussion of Article 23 of the U.S.-U.K. tax treaty in the Treasury Department's Technical Explanation, 3 CCH Tax Treaties Para. 10,941.

regulations do not specifically address the issues raised by the use of hybrid entities. Likewise, the regulations adopted in 1988 under Section 904 do not address issues raised by hybrid entities.

Although none of the cases involving tax-motivated transactions, such as Gregory v. Helvering[13] and ACM Partnership v. Commissioner,[14] has involved transactions intended to generate foreign tax credits, there is no reason to conclude that the "common law" rules established by these cases would not apply in an appropriate case to foreign tax credit transactions. These cases are not, of course, the basis for the Notice, which expressly states principles of existing law will also be applied to abusive transactions. The regulations will be in addition to these common law rules.

Comments on the Notice

Our comments address, first, the general approach adopted in the Notice; second, possible alternative approaches; and third, on the assumption that the general approach of the Notice may be retained, specific comments on the rules outlined in the Notice.

A. Comments on the General Approach of the Notice

1. Objective of the Notice. Although the Notice repeatedly states that its purpose is to prevent "tax-motivated" transactions that "abuse" the Section 904 limitations on cross-crediting, the actual rules set forth in the Notice appear to be

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[13] 293 U.S. 465 (1935).

[14] 73 T.C.M. 2189 (1997).

aimed at a different result — specifically, to change the "technical taxpayer" rule in the present regulations under Section 901 in any transaction within the two described categories in which the expected economic profit is insubstantial. The result provided by the Notice is to deny a credit altogether for foreign taxes paid in these transactions, implying a conclusion that the taxpayer should not be considered to have paid or otherwise borne the burden of the foreign tax at all. Concerns about cross-crediting might have been addressed more narrowly.

Nor do the rules in the Notice depend upon whether or not the particular transaction involved was "tax motivated". There is no indication that the results in any of the examples would be different had the taxpayer innocently fallen into the transaction described in the example or undertaken the transaction for a valid business purpose. Conversely, it is questionable whether the limitations on the scope of the Notice — specifically, limiting Examples (4) and (5) to cases where there is inconsistency of treatment under foreign and U.S. tax law — are consistent with a rule directed only at "abusive" transactions.

These apparent inconsistencies between the stated purpose of the Notice and the nature of the rules which it sets forth make it difficult to come to grips with what the Internal Revenue Service and Treasury have in mind. Our comments below address the Notice first as a revision of the technical taxpayer rule in the regulations under Section 901 and, in the alternative, as an extension of the basket rules of Section 904(d).

2. Change to Technical Taxpayer Rule. First, on the assumption that the Notice is intended to change the technical taxpayer rule of the Section 901 regulations in "abusive" cases, we question whether the proposed new rules are appropriate.

(a) Specifically, we question whether a rule that relies on a determination of whether expected economic profit is substantial or insubstantial is either administrable by the Service or predictable by taxpayers. From the examples, it would appear that a ratio of foreign tax credits to expected economic profit of 8.3 to 1 (or higher) is "insubstantial",[15] but there is no indication of what is not insubstantial. It is unclear, moreover, under the Notice how to identify the "arrangement" and how to determine the "expected economic profit" from the "arrangement". Although regulations may provide additional guidance on these points, we are not optimistic that any set of rules with respect to the identification of the "arrangement", the allocation of expenses to the arrangement or the determination of the gross income from the arrangement will be administrable in practice. Any such rules will inevitably be inconsistent with the general rules for allocating and apportioning interest and other expenses,[16] since with few exceptions these rules expressly reject arrangement-by-arrangement calculations.

(b) We also question whether substantiality of economic profit is an appropriate or reliable test for determining whether, in the Examples in the Notice, the taxpayer has borne the

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[15] Example (5) of the Notice.

[16] *E.g.*, Regs. §§ 1.861-8 through -12T.

burden of a foreign tax. For instance, if interest expense is taken into account, it is unlikely that the taxpayers in Examples (2) and (3) would have had an economic profit without the foreign tax credit even if, in Example (2), the bond had been held throughout the interest accrual period or, in Example (3), there had been no swap. As a general rule, any calculation that produces a non-insubstantial economic profit will always be artificial in the case of withholding taxes on interest. Had the taxpayer in Example (4) borrowed in the United States, the interest would have been taxable to the lender and the borrowing would presumably have been at the higher 10% rate hypothesized by the Example. Although the taxpayer's economic profit would then have been materially less than in the Example, the regulations promised by the Notice would not disallow the foreign tax credit that would be available, within the basket limitations, to the taxpayer. Similarly, had the taxpayer in that Example borrowed less from the foreign lender, thus increasing its profit, a foreign tax credit might have been available, although the transaction would have been just as "abusive" with respect to the leveraged part of the taxpayer's investment. The same comments may be made with respect to Example (5).

(c) Finally, to the extent that the Notice intends to address "abusive" transactions, we question whether a test that is based solely on substantiality of economic profit, and gives no consideration to the circumstances surrounding a transaction, is a reliable indicator of abuse — particularly in light of the uncertainties inherent in its application and the potential for

minor changes in the facts of a transaction to produce very different results. The specific transactions described in the Examples would be "abusive" if they were one-off transactions, without any purpose other than acquiring foreign tax credits, but the perception could be different if that was not the case — for example, if the taxpayer in Example (2) was a financial institution that regularly bought and sold debt securities.

We also note that a taxpayer who specifically relies on a foreign tax credit to make a profit is more likely to have a not-insubstantial profit than one who does not — this is because that taxpayer's profit on resale will be increased to the extent the market reduced the price at which the taxpayer bought by the foreign withholding tax.[17]

3. Extension of the Basket Rules. Treating the Notice as a statement of intent to extend the basket rules of Section 904(d) does not, of course, eliminate our concerns about the administrability of a substantiality test. In addition, it would seem more appropriate to address perceived abuses of the cross-crediting regime, not by denying a foreign tax credit entirely, but rather by limiting the extent to which a credit could offset U.S. tax on other income. For example, the foreign taxes paid in the Examples could be limited to the U.S. tax on the income derived from the transaction or, alternatively, if the credit were

[17] If, for example, the taxpayer buys a debt obligation for 1099.90, collects 100 in interest that is subject to a 5% withholding tax, and sells at 1000.10, there would be a loss of 4.80 under the Notice; but the profit under the Notice would be about .20 if the taxpayer bought at 1094.90 (i.e., the market price reflected the withholding tax), collected the 100 in interest, and sold at 1000.095.

generated in a basket, such as the financial services income basket, that generally contains low-taxed foreign income, the taxes could be "kicked out" into the general limitation basket.

While changing the cross-crediting rules therefore seems to us to be more appropriate than the approach of the Notice, we question whether the Treasury and Internal Revenue Service have the regulatory authority to impose more restrictive limitations of these types on cross-crediting. Section 904(d)(5) grants authority to prescribe "such regulations as may be necessary or appropriate for the purposes of this subsection", but this authority would not seem to extend to the creation of new limitation categories or the application of a high-tax kickout in circumstances not contemplated by the Statute.

Further, we question whether the rule set forth in the Notice, whatever its intended purpose, is consistent with the statutory basket rules of Section 904(d). While preventing cross-crediting between baskets, Section 904(d) clearly permits unlimited credits within a basket. The effect of a rule that disallows a foreign tax credit based on insubstantiality of economic profit, determined by treating foreign taxes as an expense, approaches a rule which disallows a credit for foreign income taxes imposed at too high a rate — and is thus beyond the scope of Section 904(d) and the Congressional intent.[18] We question also whether such

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[18] Congress chose to define a separate basket for taxes paid on high withholding tax interest, rather than denying a credit altogether for such taxes, in part due to a concern that disallowance would have violated U.S. income tax treaties. See Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at p. 865.

a rule is consistent with U.S. income tax treaties, which generally require that the United States grant a credit for taxes paid by a U.S. resident to the treaty country (albeit subject to applicable limitations).

B. Alternative Approaches if the Section 901 Regulations are to be changed

What, then, would be appropriate, assuming that the existence of the transactions described in the Examples requires a change in the Section 901 regulations?

1. Cross-Border Arbitrage Transactions. Turning first to the category of "cross-border tax arbitrage" transactions identified by the Notice, we think it would be better for the Treasury and Internal Revenue Service to issue regulations that deal generally with integrated tax systems (which is what is involved in Example (4)) and with hybrid entities and hybrid transactions (which is what is involved in Example (5)). These regulations might, for example, modify the technical taxpayer rule to provide that the deemed paid credit allowed to one taxpayer for corporate taxes does not include foreign taxes which the foreign country regards as paid on the income of another shareholder. This was the general direction taken by the 1980 temporary regulations under Section 901.[19]

Hybrid entities raise foreign tax credit issues similar to those raised by corporate tax systems that integrate corporate and individual taxes — the foreign investor in Example (5) is in

[19] See footnote 12 above.

the same position as the foreign investor in Example (4). This suggests that the rules for integrated tax systems and hybrid entities might be the same.

Departing from the technical taxpayer rule for allocating foreign tax credits in the context of integrated tax systems or hybrid entities will entail significant changes to the current rules. For example, a system of accounts would be needed under Section 902 in order to allocate credits to different categories of shareholders.[20] Presumably, such an account system would need to address not only allocations of current taxes, but also allocations of taxes that accrued in prior years in cases where stock is purchased from a prior owner or in a new issuance. (The issues would be somewhat similar to those presented by Section 902(c)(3).) Also, it would be necessary to provide rules on how a U.S. shareholder in a foreign corporation should determine whether other shareholders are receiving the benefit of an exclusion or credit for dividend income. These rules could be difficult to administer in cases where the stock is publicly held.

2. Withholding Tax Transactions. Turning to the category of foreign withholding tax transactions identified by the Notice, we think it would make more sense to amend the Section 901 regulations in the case of Examples (1) and (2) to provide an accrual rule — that is, a rule which would allow foreign

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[20] See paragraph 3 of the Treasury Department's technical explanation of Article 23 of the U.S.-U.K. tax treaty ("Where a United States corporation owns less than all the stock of a [U.K. resident] corporation..., the derivative tax credit will be calculated with reference solely to the proportionate interest in accumulated profits attributable to the United States shareholder"). 3 CCH Tax Treaties Para. 10,941.

withholding taxes as a credit only to the extent that they are paid on income that has been accrued (i.e., earned) by the taxpayer. In Examples (1) and (2), this would allow a credit to the taxpayer to the extent of the U.S. tax on the income that was earned by the taxpayer. This approach would be analogous, for example, to the rules addressing accrued interest and original issue discount upon sale of a debt obligation between payment dates.[21]

A pure accrual rule would be both more and less generous than the regulations promised by the Notice — more, because it would always allow the technical taxpayer a credit for the tax paid on income earned while the taxpayer was the owner of the income; less, because it would allow the technical taxpayer less than a full credit if the taxpayer was the owner for less than the full accrual period, notwithstanding that the taxpayer's expected economic profit was more than insubstantial. The operation of the rule might be confined by limiting its application to cases in which the technical taxpayer was the owner of the income in respect of which the foreign tax was withheld for less than X% of the accrual period.

We note that neither the regulations promised by the Notice nor the accrual rule suggested above is entirely consistent with the two specific statutory limitations on the foreign tax credit allowed for withholding taxes — the high withholding tax interest basket in Section 904(d)(1)(B) and the holding period requirement for dividends in Section 901(k).

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[21] See Regs. §§ 1.61-7 and 1.1441-2(b)(3) (effective January 1, 1999) and Prop. Regs. § 1.1441-3(b).

Consistent with the deference in the Notice to the enactment of Section 901(k), we would not apply the accrual rule to dividends covered by paragraphs (1) or (2) of Section 901(k). Unlike the Notice, we would extend this exclusion to dividends that are excepted from paragraphs (1) and (2) by Section 901(k)(4), at least if they are in the ordinary course, since it seems to us that this was also an exclusion that was considered appropriate by Congress. We also think that serious consideration should be given to whether an accrual rule, if adopted, should apply at all to ordinary course of business transactions by taxpayers who regularly buy and sell debt obligations in the course of their businesses. To the extent that the market does not treat the foreign tax as a cost, the effect of the accrual rule — and of the "insubstantiality" test of the Notice — on such taxpayers is to force them not to be the "technical taxpayer" — that is, either (1) to not hold debt obligations on the interest payment date or (2) to conduct the business outside of the United States through a foreign corporation that may use withholding taxes to reduce its local tax liability.

3. <u>Extension of Accrual Rule</u>. The issue identified by Examples (1) and (2) of the Notice is not limited to income that is subject to withholding tax. If a U.S. taxpayer acquires the equity of a foreign entity that holds low basis financial assets, such as net leases, and by a check-the-box or Section 338 election steps up the basis of the entity's assets, there may on a sale or disposal of the assets be a similar mismatch between the income for foreign tax purposes on which the foreign tax is paid and the economic

income earned by the U.S. taxpayer. This is not covered by the Notice but should be addressed as well.[22]

4. Allowance of Credit to Other Persons. Under both of the foregoing rules, consideration should be given to allowing a foreign tax credit to U.S. taxpayers that bore the burden of the foreign tax, even though they may not be the "technical taxpayer", where those persons would have paid the foreign tax if they had continued to hold the relevant asset at the time that the tax became due. For example, if the debt in the "cross-border arbitrage" transaction described in Example (4) had been held by the foreign subsidiary of a U.S. corporation, the regulations could provide that a portion of the tax paid by the borrowing corporation was paid by the foreign subsidiary. The analysis for Example (5) would be identical. Similarly, in the foreign withholding tax transaction of Example (2), if the bond had been purchased from a U.S. taxpayer which had held the bond since the last interest payment date, that U.S. taxpayer could be treated as having paid $4.87 of the foreign income tax. These results would be more consistent with the general purpose of the foreign tax credit rules to allow a credit to a U.S. taxpayer who has borne the burden of a foreign tax. In addition, we believe that this would be more consistent with the basket rules of Section 904(d), in that, once the amount of foreign tax borne by a particular U.S. taxpayer was determined, that taxpayer would be permitted to cross-credit the

[22] Cf. Section 338(h)(16), which generally suspends the usual source and basket rules when a Section 338 election is made.

foreign tax within the applicable basket to the full extent permitted by Section 904(d).

We recognize, however, that an accrual rule for foreign withholding taxes poses significant administrative and other difficulties — it could potentially divide the foreign tax among many taxpayers and could result in the allocation of the tax on a basis that did not reflect the burden of the tax. For example, where a publicly-traded security is bought and sold numerous times between interest payment dates, a withholding tax imposed on an interest payment might in theory be allocable to a large number of interim holders — some of whom, moreover, could be persons on whom the withholding tax would not have been imposed if they had been the holder of security on the interest payment date. In addition, as the number of holders increases, so do the difficulties of proving which persons held a security and during which periods.

Finally, if there are exceptions to the accrual rule for a class of income (for example, an exception in the case of interest for taxpayers who regularly buy and sell debt securities in the course of business), then it may not under any circumstances be possible to allow a credit to a person other than the technical taxpayer — to do so could result in the allowance of credits in excess of the tax actually paid.

These issues argue for limiting the extent to which a taxpayer other than the technical taxpayer would be allowed a credit for withholding taxes. It might, for example, be limited to withholding taxes paid with respect to non-publicly traded securities. In addition, we would suggest that the credit be

allowed only where (i) a foreign withholding tax is actually paid[23] and (ii) the taxpayer could prove the dates on which it held the relevant security, based on independent documentary evidence, i.e., documentation maintained for some other non-tax purpose, such as a purchase or sale contract.

5. Coordination with Section 901(k). Example (3) essentially extends to interest the rule that Section 901(k) applies to dividends — if the taxpayer had entered into an equity swap and hedged the swap by the purchase of the related equity, the credit would have been disallowed by Section 901(k)(1)(A)(ii), subject to the exception for securities dealers in Section 901(k)(4). To be sure, the explicit criteria are different — the Notice turns on the insubstantiality of the expected economic profit and Section 901(k)(1)(A)(ii) turns on the taxpayer's obligation to make related payments — but the coverage of the two rules will in most cases be identical. It seems to us that what is objectionable in the transaction described in Example (3) is simply too close to what Congress specifically addressed in Section 901(k) in the case of dividends and that, under the circumstances, the Treasury and Internal Revenue Service should proceed in this context (if at all) by seeking legislation to expand the scope of Section 901(k). Further, if this were done, we believe that it would be necessary to take into account the differences between equity hedges and debt hedges — for example, it would not seem

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[23] In other words, an interim holder who would have been subject to withholding tax if it had held a security on the payment date could not claim a credit if the security were held on the payment date by a person who was not subject to withholding tax.

appropriate to apply Section 901(k) treatment where only interest rate risk is hedged.

6. Regulatory Process. We do not question the authority of the Treasury and Internal Revenue Service to revise the technical taxpayer rules in the regulations under Section 901 or to apply the principles of present law to abusive transactions. We also have no objection to the issuance of notices that promise the issuance of regulations, to be effective from the date of issuance of the regulations, to deal with abusive tax-motivated transactions. We do not believe, however, that the Notice is a notice that will apply only to "abusive" tax-motivated transactions — as we have said, the effect of the Notice is to revise the technical taxpayer rule, albeit in limited cases. That rule has been in the present regulations since 1983. If it is to be revisited, we think that the process should be similar to that which took place in connection with the 1983 regulations, i.e., regulations should be proposed for public comment and should not take effect until a final version has been published.[24] In this regard, we note that the alternative approach we have suggested likewise would not apply solely to "abusive" transactions and thus, if followed, should also be considered in the context of the normal regulatory process.

The fact that Congress has so often examined the foreign tax credit rules in the last two decades, and that there are so many statutory limitations on the foreign tax credit, makes the

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[24] The 1983 Regulations apply to taxable years beginning after the date of adoption, November 14, 1983, unless the taxpayer elects to apply the regulations to earlier years.

case for proceeding deliberately even more compelling than it was when the regulations were changed in 1983.

In urging that the normal process of issuing regulations be followed, we do not imply that all of the changes that might be necessary to implement the Notice are within the scope of the existing regulatory authority — legislation may be required to extend the accrual rule to built-in gains (see B.3 above) and also for some of the changes that may be required to deal with hybrid entities and integrated tax systems. It appears likely that the legislative process will provide an opportunity for such legislation this year.

C. Specific Comments on the Notice.

Assuming that, notwithstanding our recommendations, the Treasury and the Internal Revenue Service do issue regulations that reflect the Notice, we have the following specific comments:

1. Effective date. The proposed effective date of the regulations is for taxes "paid or accrued" after December 23, 1997. As a consequence, it will, for example, apply to taxes imposed for all of 1997, assuming that they are imposed on a calendar year basis and so can be accrued only at year end. We think that this is inappropriate, particularly in light of the fact that the Notice was issued only eight days prior to the end of 1997. Further, while a retroactive effective date might be justified with respect to truly abusive transactions, we do not believe that the Notice is sufficiently clear on what constitutes an "abuse" in this context

to justify retroactivity for the regulations that are promised by the Notice.

As previously noted, we have no objection to notices promising immediately effective regulations to deal with abusive transactions. It is difficult, however, to define abuse precisely in the case of the foreign tax credit, particularly when the "abuse" seems to turn on the use of the technical taxpayer rule that was adopted by the Internal Revenue Service and the Treasury 15 years ago. If an immediate effective date is adopted, therefore, it should be limited to cases that are factually very close to the Examples, and the facts of the Examples should make it clear that they are one-off transactions that were entered into solely for the purpose of acquiring foreign tax credits.

2. Dividends covered by Section 901(k)(4). The Notice states that it will not apply to dividends subject to Section 901(k)(1), but will apply to dividends that are excepted from that rule by Section 901(k)(4). The limitation presumably reflects the view that it was inappropriate to apply the new rule to dividends covered by the holding period rule in Section 901(k) because Congress had so recently examined the area. For the same reason, however, it does not seem appropriate to apply the Notice to dividends that are covered by the explicit exception in Section 901(k)(4), at least in the case of transactions entered into in the ordinary course of business. We recognize that Section 901(k)(4)(C) contemplates the issuance of regulations to prevent abuse of the exception, but we believe that the Notice exceeds the scope of this limited grant of authority.

3. Deduction of foreign taxes where credit disallowed. The regulations should specify clearly that any foreign tax for which a credit is disallowed may be claimed as a deduction. See, e.g., Section 901(k)(7).

4. Financial services and passive income. In evaluating the transactions identified in Examples (4) and (5), consideration should be given to the fact that, as a practical matter, the issues raised are largely limited to the foreign income taxes paid on financial services or passive income. While it is possible that a manufacturing operation might issue a hybrid instrument which had the same effect on income from that operation as in Example (4) or (5), in our experience it is unlikely that this would occur — the expected economic profit would in almost all cases not be insubstantial. This may suggest that regulations with respect to cross-border arbitrage situations that are issued pursuant to the Notice could be limited to the income in the financial services and passive income baskets.[25]

5. Economic profit test. Any regulations which require that there be a not insubstantial profit should specify as precisely as possible, as a percentage or ratio, what is not insubstantial, whether by example or otherwise. There is no reason why the test cannot be a bright-line test. In this regard, we note that the Notice specifically refers to an intention to adopt an "objective approach". In the absence of a precise guideline on the amount of profit that will be considered substantial, the substantiality test will effectively be subjective, rather than

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[25] Before the high-tax kickout.

objective, regardless of how precise the rules are for calculating economic profit and credits.

The Notice also states that expected economic profit must be determined in a manner that reflects the likelihood of realizing both potential gain and potential loss. Does this mean that the taxpayer must assess the probability of gain or loss and apply a discount factor? If so, the regulations should provide guidance on how a taxpayer is to assess the probability of gain or loss and how to reflect these probabilities in the computation of expected economic profit. We note, also, that adjustments of this sort will inevitably be highly subjective.

6. Definition of "arrangement". The Notice is unclear as to what constitutes an "arrangement" for purposes of calculating the expected economic profit with respect to a transaction, and how arrangements will be delineated in the regulations.

In particular, we are concerned that the "facts and circumstances" approach suggested in the Notice for determining when a transaction is included within an arrangement could lend itself to "cherrypicking" by examiners and will make it virtually impossible for taxpayers to conclude with any certainty whether they fall within the scope of the regulations. At a minimum, the regulations should include a variety of examples illustrating the application of the facts and circumstances approach. Preferably, however, the regulations would provide some substantive rules for determining the components of an arrangement — for example, transactions that are entered into within a specified time period

and pursuant to documentation that makes clear the relationship among the transactions.

In addition, we believe that special rules may be needed for taxpayers that are financial institutions, such as securities dealers or banks. A transaction-by-transaction approach to the definition of arrangement could result in these taxpayers being denied substantially all of their foreign tax credits, both because profit margins on individual transactions tend to be low and because a taxpayer may enter into a transaction that generates a loss but is part of a larger portfolio of transactions that are profitable overall. Therefore, consideration should be given to adopting a portfolio approach in defining an "arrangement" for securities dealers and other financial institutions — at least with respect to transactions entered into in the ordinary course of business.

7. Allocation of interest expense. The Notice seems to contemplate that the regulations will — at least in the case of non-hedged transactions — apply a tracing approach to allocate interest expense, taking into account relevant facts and circumstances. There is, however, uncertainty on this point — that is, whether the Notice means that interest expense will *only* be allocated if it can be traced, or that interest expense will be allocated under the general fungibility rule unless it can be traced. None of the examples refer to interest that is not specifically traceable, and the text of the Notice says that interest expense will be taken into account only if it "is part of the arrangement". As a consequence, we have assumed that the first

interpretation is what was intended, although others believe that this may not be the case.

A tracing approach would be inconsistent with the fungibility approach provided in Section 864(e) of the Code and the regulations thereunder. Section 864(e)(7) contemplates only limited exceptions to the fungibility rule, and the Treasury and Internal Revenue Service have been very reluctant to date to expand on the scope of those exceptions. The Notice does not clearly explain, however, why a departure from the general fungibility rule is appropriate in this context. Further, as in the case of the definition of "arrangement", we are concerned that a tracing approach based on facts and circumstances could lend itself to "cherrypicking" and could introduce a high degree of uncertainty to the economic profit test.

If, notwithstanding the above, a tracing approach is adopted for interest expense, we suggest that indebtedness be traced to an arrangement only where the debt is a functional element of the transaction — in other words, where its presence is necessary to achieve the benefits of the transaction. While this rule is admittedly a narrow one, we believe that it is appropriate to limit the scope of a tracing rule in the context of regulations that are designed to distinguish between abusive and non-abusive transactions. It does not seem appropriate to establish rules under which a transaction may be characterized as abusive or non-abusive depending simply on whether the taxpayer has sufficient equity funds available for investment or instead is required to borrow in order to make the investment.

In addition, consideration should be given to whether different interest allocation methods should apply to different types of taxpayers. For example, a tracing approach seems particularly inappropriate for banks and securities dealers — for the same reasons that a portfolio approach is more appropriate in defining an "arrangement" for these taxpayers, it would be more appropriate to take into account their overall cost of funds, rather than the interest expense incurred with respect to a specific borrowing.

Finally, the Notice states that different interest expense allocation rules — specifically, rules that do not use a tracing approach — will apply in connection with hedged transactions. It is not clear from the Notice, however, what those rules will be. For example, will they apply a fungibility approach, or will they simply assume that a hedged transaction is 100% debt-financed? It is also not clear to us why different rules should apply to hedged and non-hedged transactions.

8. Specific comments on certain of the Examples. We question the inclusion of Example (1). It is difficult to believe that such a transaction would, under present law, provide the taxpayer with a basis to conclude that it had acquired the income.[26] Indeed, it is even questionable whether the taxpayer would be regarded as the person liable for the tax under foreign law.

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[26] Cf. Helvering v. Horst, 311 U.S. 112 (1940); and Commissioner v. Oxford Paper Co., 194 F.2d 190 (2d Cir. 1951).

With regard to Example (2), we question the reservation as to whether the interest, which is subject to 4.9% withholding tax, may nonetheless be high withholding tax interest in the hands of the taxpayer. This seems inconsistent with the terms of the statute — in any event, the issue should be addressed separately by regulations issued under Section 904(d)(2)(B).

9. Non-abusive transactions. The Notice should contain examples of transactions that the Treasury and the Internal Revenue Service do not consider abusive. For example, in response to comments, the final partnership anti-abuse regulations under Section 701 contain several examples of non-abusive transactions. We note also that one of those examples specifically provides that the mere selection of the partnership form of entity in order to avail oneself of foreign tax credits is not an abuse.[27] Examples (4) and (5) of the Notice do not seem consistent with this conclusion.

10. Other guidance. Part III of the Notice indicates that the regulations will provide special rules that will work to deny foreign tax credits in "abusive" transactions involving asset swaps or other hedging devices. In Part VI of the Notice, Treasury and the Internal Revenue Service have also stated that they are considering additional guidance (whether in the form of regulations or otherwise) with respect to the withholding tax transactions discussed in the Notice in situations where the taxpayer has hedged its investment in the relevant asset or income stream. The Notice indicates that the additional guidance described in Part VI will be

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[27] See Regs. § 1.701-2 (Example 3).

effective on a prospective basis only, but the intended effective date of the guidance on hedging transactions described in Part III is not clear. We recommend that any guidance with respect to the effect of hedging arrangements be the subject of regulations, and that these regulations be effective no earlier than the date on which proposed regulations are issued.