

**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

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

**October 25, 2007**

## TABLE OF CONTENTS

<b>I. INTRODUCTION.....</b>	<b>1</b>
<b>II. SUMMARY OF RECOMMENDATIONS.....</b>	<b>3</b>
A. U.S.-Owned Foreign Groups.....	3
B. Structured Passive Investment Arrangements.....	4
C. Effective Dates .....	5
<b>III. U.S.-OWNED FOREIGN GROUPS .....</b>	<b>6</b>
A. Overview of Provision .....	6
B. Comments on Proposed Regulations .....	9
1. Recommended Approach .....	9
2. Technical Comments.....	14
<b>IV. CERTAIN STRUCTURED PASSIVE INVESTMENT ARRANGEMENTS... 18</b>	
A. Background to Proposed Regulations .....	18
B. Overview of Proposed SPIA Rules .....	19
C. Comments on General Approach of Proposed SPIA Rules .....	21
1. Use of Bright-Line Tests .....	21
2. Application of Compulsory Payment Rules to Curb SPIAs .....	24
3. Appropriateness of Different Treatment of Active and Passive Activities .....	27
D. Comments on Six Conditions for SPIA Status .....	29
1. SPV Definition .....	30
2. U.S. Party .....	38
3. Direct Investment .....	38
4. Foreign Tax Benefit .....	41
5. Unrelated Counterparty .....	43
6. Inconsistent Treatment .....	45
E. Consequences of SPIA Classification .....	47
1. Amount of Disallowed Foreign Tax Credits .....	47
2. Treatment of Non-Creditable Taxes.....	50
<b>V. EFFECTIVE DATES.....</b>	<b>50</b>

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<sup>1</sup> on proposed amendments to Treas. Reg. § 1.901-2(e)(5) (the “proposed regulations”),<sup>2</sup> 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

---

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”).<sup>3</sup> 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

---

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)<sup>4</sup> 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.

---

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. Effective Dates

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.<sup>5</sup>

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).<sup>6</sup> 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.<sup>7</sup> 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.<sup>8</sup> The proposed regulations would also

---

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.<sup>9</sup> 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.

---

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.<sup>10</sup> 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.<sup>11</sup>

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.

---

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.<sup>12</sup> 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.<sup>13</sup> 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.<sup>14</sup>

---

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.”<sup>15</sup> 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<sup>16</sup> 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.<sup>17</sup>

(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.<sup>18</sup>

(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.<sup>19</sup>

(iv) *Foreign tax benefit*: The arrangement results in a foreign tax benefit to a counterparty described in (v) below.<sup>20</sup>

(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.<sup>21</sup>

---

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.<sup>22</sup>

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”).<sup>23</sup> 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.<sup>24</sup> 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.”<sup>25</sup> 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

---

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.<sup>26</sup>

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.

---

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.



tax results claimed in connection with such arrangements, including the substance over form doctrine, the economic substance doctrine, debt-equity principles, tax ownership principles, existing [Treas. Reg.] § 1.901-2(e), section 269, and the partnership anti-abuse rules of [Treas. Reg.] § 1.701-2.”<sup>27</sup> The Preamble adds that “[n]o inference is intended” regarding the U.S. tax consequences of SPIAs prior to the effective date.<sup>28</sup>

The proposed regulations do not provide explicit guidance as to the treatment of post-effective date transactions that do not meet all six of the specified conditions. However, the Preamble states as follows:

“For periods after the effective date of final regulations, the IRS and Treasury Department will continue to scrutinize other arrangements that are not covered by the regulations but are inconsistent with the purpose of the foreign tax credit. Such arrangements may include arrangements that are similar to arrangements described in the proposed regulations, but that do not meet all of the conditions included in the proposed regulations. The IRS will utilize all available tools, including those described above, to challenge the claimed U.S. tax results in appropriate cases. In addition, the IRS and Treasury Department may issue additional regulations in the future in order to address such other arrangements.”<sup>29</sup>

We recognize that transactions falling outside the SPIA rules may nonetheless be abusive, and we support the use of judicially-created doctrines to challenge them. However, it should be made clear that arrangements that fall outside the SPIA rules but in which there is a legal liability to pay foreign tax should not be subject to attack on the ground that the related foreign taxes are not “compulsory payments,” and

---

27. Preamble, ¶ B.3. Certain of these doctrines were also cited in Notice 2004-19 as possible tools for attacking abusive foreign tax credit transactions.

28. Preamble, ¶ C.

29. Preamble, ¶ B.3.

that the regulations when finalized will not cause arrangements to be vulnerable simply on the basis that they are “almost” SPIAs.

2. Application of Compulsory Payment Rules to Curb SPIAs

It is noteworthy that the mechanism adopted by the government to attack SPIAs is an expansion of the compulsory payment rules. The new rules relating to SPIAs that are contained in Prop. Treas. Reg. § 1.901-2(e)(5)(iv) represent a marked departure from the current Treas. Reg. § 1.901-2(e)(5) insofar as they would deny credits for foreign taxes that are clearly compulsory in the sense that there is a legal obligation to pay the taxes under foreign law. As indicated in the Preamble, however, the government believes that it is not appropriate to allow a credit for foreign taxes arising in the three categories of “highly engineered transactions” that it has identified (U.S. borrower, U.S. lender, and asset holding transactions), where there is “an incentive for the U.S. person to subject itself voluntarily to the foreign tax because there is a U.S. tax motivation to do so,” and “the U.S. taxpayer benefits by intentionally subjecting itself to foreign tax” through “intentionally structuring a transaction” in an “elaborately engineered” manner.<sup>30</sup> The government has concluded that SPIA transactions can be viewed as generating noncompulsory, voluntary tax payments, and accordingly seeks to curb SPIAs by revising and expanding the definition of “non-compulsory payment” under current Treas. Reg. § 1.901-2(e)(5).

Some commentators have argued that the IRS does not have the authority to attack SPIAs either by its chosen approach of expanding the scope of the compulsory

---

<sup>30</sup> Preamble, ¶ B.2-3.

payment rules or by similar bright-line regulations, as opposed to reliance on judicially-created doctrines. The basis for this assertion is that the payments in question are foreign income taxes within the ordinary meaning of the term and Section 901 on its face permits a credit.<sup>31</sup> A substantial majority of our Executive Committee believes that the IRS does have the authority to promulgate the proposed regulations under Sections 7805(a) (granting the IRS authority to “prescribe all needful rules and regulations for the enforcement of this title”) and 7701(l) (granting authority to “prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title”). Therefore, we believe that the IRS has the authority to implement its decision to address SPIAs by expanding the scope of the compulsory payment rules.

However, a number of us believe that there is a potential issue as to the validity of the proposed regulations. Accordingly, we believe that the IRS should consider taking steps to strengthen the SPIA rules in the proposed regulations against a possible challenge to their validity. First, it would be helpful if the IRS were to articulate more explicitly the statutory authority basis for these regulations. In addition to citing Section 7805(a) in connection with the discussion of why the three categories of transactions described in the Preamble are inconsistent with the purpose of the foreign tax credit, the Preamble could refer to Section 7701(l). Each of the three categories of

---

31. Some commentators have noted that the American Jobs Creation Act of 2004 as enacted did not include the provision in the Senate version that would have given the government express authority to address foreign tax credit arbitrage transactions. Jumpstart Our Business Strength (JOBS) Act, S. 1637, § 661A, 108<sup>th</sup> Cong. (2d Sess. 2004).

transactions described in the Preamble involves a financing transaction between a U.S. person and a foreign counterparty using an SPV. Section 7701(l) authorizes the IRS to recharacterize certain highly structured multi-party transactions as transactions directly among two or more of the parties involved. In many cases, the proposed regulations basically achieve the result of such a recharacterization – denial of a foreign tax credit to the U.S. person – without explicitly setting forth such a recharacterization.<sup>32</sup> While we do not believe it is essential that the SPIA regulations provide for such a recharacterization in order to be a valid exercise of its regulatory authority, the IRS might consider doing so, and in any event should articulate the Section 7701(l) analysis in the preamble to the regulations in their final form. Another possible source of authority is the subsidy rules of Section 901(i). The foreign tax benefit received by the foreign counterparty as a result of the SPV’s foreign tax payment could be viewed as a subsidy, resulting in disallowance of the credit. However, the subsidy rules traditionally have not been applied in this manner, and it is unclear that Section 901(i) is intended to apply unless the foreign government is deliberately conferring a benefit in order to encourage certain behavior.

Second, as discussed in greater detail below, we believe the proposed regulations are overbroad in certain respects and may result in the disallowance of foreign tax credits in a number of situations and/or in amounts that cannot reasonably be justified as necessary or appropriate to curtail abusive transactions. The risk that the

---

32. However, some transactions covered by the SPIA rules are not readily susceptible to recharacterization under Section 7701(l). For example, the SPV is not a party to a “repo” transaction in which the U.S. person “sells” SPV stock to a foreign counterparty subject to a repurchase obligation.

regulations might be successfully challenged as an invalid exercise of regulatory authority would be minimized if the regulations were clarified, refined and narrowed as discussed below so as to eliminate such overbreadth.

Wholly apart from any possible validity issue, it is arguably anomalous that treatment of taxes as not compulsory under the proposed regulations requires an arbitrage transaction. In the absence of a foreign tax benefit provided to a foreign counterparty, the proposed regulations do not penalize a U.S. taxpayer that parks its passive investments in a foreign subsidiary that incurs foreign tax liabilities, even though the foreign tax payments are no less voluntary than in the arbitrage cases covered by the proposed SPIA rules. This distinction is justifiable, however, on the practical basis that, in the absence of an arbitrage transaction, there generally is less of an incentive to incur the foreign tax liability, and structuring an investment in a manner that results in foreign tax liability without a business motivation therefore is less likely to happen. In any event, we do not consider this anomaly a problem in the practical application of the proposed regulations.

3. Appropriateness of Different Treatment of Active and Passive Activities

The proposed regulations make a fundamental distinction between entities that generate primarily passive investment income and are therefore potentially subject to the SPIA rules, and entities that generate active income and are therefore not subject to the SPIA rules even if the entities or their owners engage in arbitrage transactions with foreign counterparties. Subject to our comments at IV.D.1, below, concerning the proposed regulations' definition of "passive investment income," we agree with the general approach of differential treatment of passive and active income.

The basic distinction between active and passive activities drawn by the proposed regulations can be illustrated through two basic examples:

*Example 3:* A U.S. corporation (“USP”) contributes cash to a newly created Country X corporation (“Newco”). Newco invests the cash in portfolio investments that would not be subject to foreign tax if owned directly by USP. Newco is subject to Country X tax on income generated by the investments. USP enters into a repurchase transaction in which it “sells” 75 percent of the stock of Newco to an unrelated Country X corporation (“FC”), subject to an obligation to repurchase the shares in five years. Dividends and repurchase proceeds provide FC with a fixed rate of return. For Country X tax purposes, FC is treated as the owner of the “purchased” Newco shares but is not subject to Country X tax on the dividends based upon a participation exemption. For U.S. tax purposes, the transaction is treated as a loan from FC to USP.

*Example 4:* Same facts as Example 3, except that Newco invests the contributed cash in an active manufacturing business that it conducts directly.

In both examples, under current law, USP would be required to include in income dividends paid by Newco to FC and would be entitled to a foreign tax credit for taxes paid by Newco and a deduction for “interest” paid or accrued on the “loan” from FC. Under the proposed regulations, USP would be denied foreign tax credits for taxes paid by Newco in Example 3 but not in Example 4.

We believe that the difference in results in the two examples is justifiable. In the case of Example 4, it is likely that USP would have funded Newco’s active business operations in the absence of the repurchase transaction with FC. The foreign tax benefits derived by FC in most cases result in a pre-tax cost of funds to USP that is lower than the interest rate at which USP could have borrowed from a U.S. bank to fund its investment in Newco. If Newco had paid dividends to USP to enable USP to service its U.S. bank debt, USP would have recognized the same amount of dividend income and been entitled to the same amount of foreign tax credits as in Example 4. The only

difference in U.S. tax results between the U.S. bank borrowing transaction and the repurchase transaction with FC is that the repurchase transaction typically would result in a lower interest deduction and therefore in a higher U.S. tax liability.

By contrast, decisions as to whether to invest in passive assets and whether to hold them in a manner that attracts foreign tax liability are more likely to be driven by tax considerations, including the ability to use an arbitrage transaction to effectively share the economic cost of the creditable foreign tax and in some cases to generate foreign tax credits that could be used to shelter unrelated foreign source income. In theory, an arbitrage transaction could be structured with a pre-existing foreign subsidiary that already owns passive assets, and it could be argued that the arbitrage transaction simply facilitates inexpensive financing for the U.S. shareholder to fund investments in other business activities. However, as a practical matter arrangements involving passive assets are inherently more subject to abuse than are arrangements involving active business assets.

D. Comments on Six Conditions for SPIA Status

The proposed regulations set forth six separate conditions, all of which must be met for an arrangement to be classified as an SPIA. Although each of these criteria is nominally distinct from the others, our views on some of the criteria are affected both by how certain other criteria are ultimately formulated as well as by the effect of the All-or-Nothing Rule.

We assume that it is intended that SPIA treatment applies only with respect to foreign taxes paid or accrued in periods in which all six conditions are met. The proposed regulations should be clarified in this regard. More specifically, we

recommend that the final regulations (1) only apply to foreign taxes paid or accrued in taxable years in which each of the six conditions is satisfied during at least part of the year, although not necessarily all at any one time during the year, and (2) apply in accordance with their underlying principles in situations in which one or more of the conditions is met during only part of the year. Where a U.S. person acquires the stock of an SPV during a tax year, the tax year of the SPV should be treated as ending and a new year should be treated as beginning on the date of the change in ownership for purposes of applying the SPIA rules. Each period should then be analyzed separately for purposes of determining whether the SPIA conditions are met. To the extent that the U.S. person could otherwise claim a credit for taxes paid in the preacquisition period, the “U.S. person” condition should be considered to have been met in that period.

1. SPV Definition

An entity is an SPV if “substantially all” of its gross income is “passive investment income” and “substantially all” of its assets are held for the production of passive investment income. We believe that there are reasonable arguments both for and against substituting a specific percentage for the words “substantially all.” On the one hand, a definition of SPV that is dependent upon a “substantially all” test cuts against the certainty that we feel is a cardinal virtue of the proposed SPIA rules for both taxpayers and the government. On the other hand, retention of the less specific “substantially all” language should have a desirable deterrent effect on taxpayers who could otherwise plan to fit below a specific threshold. As a middle ground, the regulations could retain the “substantially all” language but provide examples where the test is met (perhaps at an 80 percent level) and not met (perhaps at a 60 percent level).



“Passive investment income” is defined by reference to the foreign personal holding company income definition of Section 954(c).<sup>33</sup> However, Sections 954(c)(3) (the “same country exception”) and 954(c)(6) (the exception for payments between related controlled foreign corporations (“CFCs”)) are disregarded.

*Example 5:* Same facts as Example 4, except that instead of using cash directly in an active business, Newco lends the funds to F Sub, a CFC wholly-owned by USP, all the assets of which are used in an active trade or business.

In Example 5, Newco would be treated as an SPIA under the proposed regulations. Members of the group that prepared this report have differing views as to whether this is the proper result.

Those of us who are of the view that Section 954(c)(6) principles should not apply believe that the line drawn between passive and active income by the proposed regulations only makes sense if “passive” for this purpose includes income that is passive under general principles, even if Section 954(c)(6) makes it “active” for other purposes. There are two reasons for this conclusion. First, the Preamble makes clear that the regulations are aimed at “highly engineered transactions where the U.S. taxpayer benefits by intentionally subjecting itself to foreign tax.” Whether a particular transaction meets this description does not depend on whether the assets of the foreign corporation consist of loans to third parties or loans to “active” affiliates. In the case of a transaction involving loans to an active affiliate, the actual active assets are “outside” the transaction in a sister corporation, the level of financial engineering is equally as great as in the case of loans to a third party, and each party is in exactly the same economic position as if the

---

33. Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(C)(4)(i).

SPV made loans to a third party. Both kinds of transactions are pure financial transactions. As a result, those of us who believe that Section 954(c)(6) principles should not apply see no logical or policy basis for making a distinction between the two cases and think that both types of transactions should be equally prohibited for the reasons stated in the Preamble. Second, if Section 954(c)(6) applies for purposes of the proposed regulations, any corporate group with an active foreign subsidiary could set up a financial subsidiary to make loans to active affiliates and engage in these transactions. Those of us who are of the view that Section 954(c)(6) principles should not apply believe that a considerable number of “highly engineered transactions” in this area would continue, and that investment banks and others would continue marketing these transactions just as before if those principles applied.

Other members of the group believe that Section 954(c)(6) principles should apply. As discussed at IV.C.3, above, we approve of the distinction made by the proposed regulations between active and passive activities. In these members’ view, the regulations are intended to prevent U.S. taxpayers from deriving tax benefits by holding passive assets offshore, and the appropriate inquiry is thus whether the assets are used by a group of related foreign entities in an active foreign business, regardless of whether the active business is conducted directly by the entity in question or by a related party to which such entity lends the funds. Although using a finance subsidiary in a brother-sister structure rather than a single foreign entity that directly conducts the active business might facilitate tax-advantaged financing transactions, these members believe that this

distinction is not germane to the policy underlying the active/passive distinction.<sup>34</sup> Moreover, the principles of Section 954(c)(6), under which otherwise passive income derived from a related foreign party is treated as passive only to the extent that it is properly attributable to passive income of the payor, are consistent with the look-through rules of Section 904(d)(3), which applies to distinguish between active and passive income for purposes of the foreign tax credit separate limitation rules and Section 1297(b)(2)(C), which governs the characterization of related party income for purposes of determining PFIC status. Those of us who support the application of Section 954(c)(6) principles believe that the proposed regulations' stated policy objective of eliminating the incentive to hold passive assets offshore does not apply to assets deployed in active business activities, regardless of whether they are conducted directly by an SPV or indirectly by a party that is financed by an SPV. Those of us who support this approach believe that it is appropriate for this purpose even if Section 954(c)(6) expires after 2008 as scheduled.

The proposed regulations also provide that in determining whether income is described in Section 954(c), Section 954(h) and (i) shall be applied as if the SPV were a CFC. The proposed regulations further provide that transactions with a counterparty shall not be treated as qualified banking or financing income or as qualified insurance income for purposes of determining qualification under Sections 954(h) and (i). We do not believe that Section 954(h) provides an entirely appropriate basis for distinguishing between active income from a banking or financing business and passive investment

---

34. In fact, use of a foreign finance subsidiary to fund a group's foreign business operations is often motivated in part by a desire to reduce foreign taxes, which might be viewed favorably by the IRS.

income in the context of the SPIA rules. The focus of Section 954(h) on business being conducted in the CFC's home country and income being subject to home country tax is appropriate for subpart F's anti-deferral regime, but is of little if any relevance for purposes of determining eligibility of taxes paid by a foreign entity for foreign tax credits. Moreover, the proposed regulations are unclear as to what is intended to happen if Section 954(h) expires as scheduled. We believe that a more appropriate test would be to apply Section 954(h) principles without regard to the home country-related limitations (*e.g.*, the 30 percent requirement). Alternatively, in light of the scheduled expiration of Section 954(h), income could be treated as active business income if it is financial services income described in Section 904(d)(2)(D)(ii) and is derived from a person unrelated to the U.S. taxpayer and the foreign counterparty, and the foreign entity is engaged directly (rather than merely through affiliates) in the active conduct of a banking, financing or similar business using its own employees.<sup>35</sup>

The proposed regulations provide special rules for equity interests in lower-tier entities.<sup>36</sup> Income attributable to an equity interest in a lower-tier entity (including for this purpose a corporation, trust, partnership or disregarded entity<sup>37</sup>) generally is treated as passive investment income. However, income of a "holding company" derived from a "qualified equity interest" in a lower-tier entity is not treated as passive investment income. An entity is a holding company if substantially all of its

---

35. Alternatively, common law principles could apply to the active business determination, but application of such principles likely would not add to certainty of results.

36. Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(C)(4)(ii).

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

assets consist of qualified equity interests in one or more entities, each of which derives more than 50 percent of its gross income from the active conduct of a trade or business. A qualified equity interest is defined as a 10 percent or greater interest by vote or value in a lower-tier entity, but does not include preferred stock as defined in Section 351(g)(3).<sup>38</sup>

We believe the holding company rules are overly limited in a number of respects. First, a qualified equity interest in a lower-tier entity predominantly engaged in an active trade or business should be treated as a non-passive asset regardless of whether substantially all the assets of the entity being tested consist of such qualified equity interests. This issue can be illustrated by the following example:

*Example 6:* 20 percent of Newco’s assets consist of assets held for the production of passive investment income, 20 percent consist of assets used by Newco directly in an active business, and the remaining 60 percent consist of stock in a wholly-owned subsidiary, F Sub, all the assets of which are used in an active business.

Because Newco in Example 6 is not a “holding company” (assuming that 60 percent is not “substantially all”), the equity interest in F Sub is a “passive” asset under the proposed regulations. Accordingly, 80 percent (which likely would be viewed as substantially all) of its assets would consist of assets held for production of passive income. If Newco did not own the stock of F Sub, only 50 percent (clearly less than substantially all) of its assets would be passive assets. If all the assets held directly by Newco were instead held by F Sub, Newco would be a holding company (because the stock of F Sub would be its only asset) and none of its assets would be passive. Moreover, under the facts of Example 6, it appears that F Sub’s income would be treated

---

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

as passive investment income of Newco if F Sub were treated as a pass-through entity for U.S. tax purposes,<sup>39</sup> but otherwise would be ignored unless distributed. These results are difficult to reconcile.

Second, income other than dividend income (*e.g.*, interest and royalty income) received from a lower-tier entity that is predominantly engaged in an active business and in which the entity being tested owns a qualified equity interest should not be treated as passive investment income. Similarly, dividends received with respect to preferred stock of a subsidiary that is predominantly engaged in an active business should not be treated as passive, although it is appropriate to exclude preferred stock from the determination of whether the ownership threshold for a qualified equity interest is met.

Third, the proposed regulations appear not to permit look-through treatment for second-tier subsidiaries of putative SPVs.

Fourth, a lower-tier entity should be treated as active if either more than 50 percent of its gross income is active business income or more than 50 percent of its assets are held for production of such income. Incorporating an asset test along with the income test would be more consistent with the general SPV definition and would reduce the likelihood of disqualifying start-up entities with active businesses that have not yet started generating substantial income other than interest on working capital.

A sounder overall approach to the lower-tier entity issue, which would address the specific concerns with the proposed regulations' holding company provisions noted above, would be to apply look-through treatment to income and assets of lower-tier

---

39. The income test in Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(B)(I)(i) refers to gross income “(for United States tax purposes).”

entities based upon the same ownership and other rules that apply under current law for purposes of determining whether a foreign corporation is a PFIC.<sup>40</sup> The PFIC rules involve similar principles and, although not perfect, are of relatively long standing and are familiar to taxpayers, and therefore serve as a helpful model.

A further limitation on the applicability of the holding company rule under the proposed regulations is that it does not apply to an interest in a lower-tier entity where there are “arrangements whereby substantially all of the entity’s opportunity for gain and risk of loss with respect to such interest is borne by the U.S. party (or a related person) or the counterparty (or a related person), but not both parties.” We do believe that this standard should be revised in a manner that is better tailored to its apparent intent. Most arbitrage transactions of the type addressed in the SPIA rules, regardless of the active or passive nature of the underlying business and regardless of whether there is a holding company involved, typically involve a foreign counterparty whose interest is limited to an entitlement to a fixed return and thus has limited opportunity for gain and risk of loss. The example in the proposed regulations illustrating this rule involves a situation in which the parties agree that no dividends will be paid by the subsidiary to the putative SPV during the period of the foreign counterparty’s “ownership.”<sup>41</sup> Although we agree that the result in the example is the correct one, we believe that the proper reason for the result is that the subsidiary’s income and assets are not available to the foreign counterparty, not that the foreign counterparty has no opportunity for gain or risk of loss.

---

40. *See* Section 1297(c) of the Code.

41. Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(D) *Example 2*.

The proposed regulations should be revised to exclude consideration of lower-tier entities where there are contractual restrictions (such as the dividend limitation in the example in the proposed regulations) on the foreign counterparty's recourse against the lower-tier entity's income or assets.

2. U.S. Party

The requirement that a U.S. person be eligible to claim a credit for all or a portion of the payment made if it were treated as a foreign tax for Section 901 purposes seems obvious on its face. However, the proposed regulations are not clear as to whether a U.S. person must have an interest in the SPV at the time the foreign tax is paid by the SPV. We recommend that the proposed regulations be amended to clarify that the "U.S. party" condition must be met at the same time as the other five conditions, subject to the discussion at the beginning of IV.D above. In theory, a U.S. person could acquire an interest in an SPV after some or all of the other conditions are no longer met and claim a Section 902 credit for the earlier period and derive a benefit from arbitrage. However, as a practical matter such a situation seems unlikely, and it is overly burdensome for a U.S. person to be responsible for ascertaining the history of an entity prior to such U.S. person's ownership.

3. Direct Investment

Under the proposed regulations, an arrangement is not an SPIA unless the foreign taxes attributable to the arrangement are (or are expected to be) "substantially greater" than the credits that would be available if the U.S. party directly owned its proportionate share of the SPV's assets, as determined by reference to the U.S. party's proportionate share of the total value of interests held by its equity owners and creditors.



In all the examples in the proposed regulations, the direct investment requirement is met because the U.S. taxpayer would not be subject to foreign tax if it owned the SPV's assets directly. However, the direct investment condition can also be met if the credits otherwise available to the U.S. taxpayer would be disproportionately large relative to the SPV's foreign tax payments that are attributable to the U.S. taxpayer's investment, as illustrated by the following example:

*Example 7:* A U.S. corporation (“USP”) invests \$100 in the stock of an SPV, and a foreign counterparty (“FC”) invests \$100 in a security issued by the SPV that is treated as equity for foreign tax purposes and debt for U.S. tax purposes. SPV invests the \$200 in a debt instrument that is subject to foreign tax at the same rate in the hands of the SPV that would apply if it were held directly by USP. The direct investment condition is met because, absent the SPIA rules, USP would be entitled to credits for the entire amount of foreign tax paid by the SPV, which is twice the amount of credits that would be available if USP directly owned its proportionate share (*i.e.*, 50 percent) of the SPV's assets.

We believe that the direct investment condition is generally appropriate.

However, we do have technical comments on the operation of this test. First, it should be clarified that the test should look to the taxes that, absent the SPIA rules, could be claimed as credits by the U.S. taxpayer; the proposed regulations as drafted appear to refer to all the taxes paid by the SPV, even if the U.S. taxpayer is not the SPV's sole equity owner for U.S. tax purposes. Second, for purposes of determining proportionality, the appropriate comparison is not with the foreign taxes which would be paid by the U.S. taxpayer if it directly owned a portion of the SPV's assets based upon its proportionate share of the SPV's equity and creditor interests. A more appropriate comparison would be with a proportionate share of the SPV's foreign tax liability equal to a fraction, the numerator of which is the value of the U.S. taxpayer's equity investment in the SPV and the denominator of which is the value of all investments in the SPV treated as equity for

U.S. or foreign tax purposes (without regard to interests treated as debt for all relevant U.S. and foreign tax purposes). The direct investment test should continue to be treated as satisfied where the SPV is subject to a higher rate of foreign tax than the rate that would be applicable to the U.S. taxpayer if it owned the SPV's assets directly. However, the provision in the proposed regulations that direct ownership does not include ownership through a branch, permanent establishment, or similar arrangement resulting in net basis taxation should not apply to assets used in an active business in the foreign country that could not be conducted directly by the U.S. taxpayer without attracting net basis taxation by such country.<sup>42</sup>

In addition, the methodology for determination of the U.S. party's proportionate share of the SPV's assets in arrangements involving repurchase transactions should be clarified.<sup>43</sup> For example, in a typical repurchase transaction arrangement such as that described in Example 3 in IV.C.3, above, the foreign counterparty is a creditor of the U.S. person rather than the SPV for U.S. tax purposes. USP owns all the interests in Newco for U.S. tax purposes, but only 25 percent of such interests for foreign tax purposes. For purposes of the "direct investment" test, we believe that a repurchase transaction is not fundamentally different from an investment by

---

42. This is potentially significant in cases in which substantially all the SPV's income is passive but the SPV does have active business activities which could not be conducted directly by the U.S. taxpayer without subjecting itself to net basis taxation. For this purpose, the definition of "active business" activities would be the definition otherwise applicable for purposes of the SPIA rules; our intent is not to suggest evisceration of Section 954(h) or other principles that might be used to distinguish between active and passive activities.

43. In the examples in the proposed regulations that involve repurchase agreements, it is specified that the U.S. taxpayer would not incur foreign tax liability if it owned the SPV's assets directly, thus avoiding the need to address this issue.

the foreign counterparty in a hybrid instrument issued by the SPV. The value of the U.S. person's interest therefore should be reduced by any amount advanced to the U.S. person from the foreign counterparty that is treated as a loan for U.S. tax purposes and results in the foreign counterparty being treated as an equity owner for foreign tax purposes. If it is not so reduced, the arrangement in Example 3 would not be an SPIA if USP would be subject to foreign withholding tax if it owned Newco's assets directly at a rate equal to the rate applicable to the SPV, even if the U.S. taxpayer never would have been willing to acquire assets subject to foreign withholding tax absent the ability to finance the investment through the arbitrage transaction with FC; taxpayers would have an artificial incentive to find such assets to own through SPVs in order to avoid the SPIA rules. On the other hand, we recognize that even under our recommended approach, taxpayers could achieve the same "double dip" effect without running afoul of the SPIA rules by directly acquiring investment assets subject to withholding tax and engaging in repurchase transactions involving direct interests in assets without using an SPV.

#### 4. Foreign Tax Benefit

SPIA treatment requires that the arrangement be structured in a manner that results in a foreign tax benefit to an unrelated foreign counterparty. "Foreign tax benefit" is broadly defined to include "a credit, deduction, loss, exemption or a disregarded payment" in any jurisdiction in which the counterparty is subject to tax on a net basis. This condition should be clarified by specifying that it applies only where the foreign tax benefit in question relates to the foreign tax paid by the SPV or results from the foreign counterparty being treated for foreign but not U.S. tax purposes as owning an equity interest in the SPV or a portion of the SPV's assets.

For example, in Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(D) *Example 4*, which addresses a “U.S. lender” transaction, the foreign counterparty’s tax benefit is the ability to deduct interest paid or accrued to a reverse hybrid subsidiary of the SPV, which is fully taxable on the interest income, and the ability to receive tax-free dividends on its interest in Newco, which is treated as stock for both U.S. and foreign tax purposes.

Treating a counterparty’s ability to claim an interest deduction on an obligation that is debt, or to claim dividend treatment on an instrument that is equity, for both foreign and U.S. income tax purposes as a “foreign tax benefit” has the practical effect of rendering this factor virtually meaningless. If the theory of the proposed regulations is that a “U.S. lender” transaction is really a loan from the U.S. taxpayer to the foreign counterparty (and that foreign tax credit consequences should flow accordingly), the ability of the foreign counterparty to claim an interest deduction should not be treated as a foreign tax benefit for purposes of evaluating SPIA status. In addition, the ability of the foreign counterparty to receive tax-free distributions from Newco does not appear to be the type of foreign tax benefit intended to be addressed by the proposed regulations, since the foreign counterparty is treated as an equity owner for both U.S. and foreign tax purposes.

This is not to say that we believe that the result that Example 4 of the proposed regulations suggests would occur in the absence of the proposed regulations is appropriate. In our view, the policy issue that is raised by the facts of the example is the separation of taxes from the underlying income. That issue is adequately addressed by Prop. Treas. Reg. § 1.901-2(f). Applying the technical taxpayer rules of Prop. Treas. Reg. § 1.901-2(f)(2)(iii), the taxes which the example treats as having been paid by the

SPV are, in fact, attributed to the SPV's reverse hybrid subsidiary, thus avoiding the concern addressed by the example.

In addition, foreign tax benefits that arise only as a result of changes in circumstances that could not be reasonably anticipated at the time of the U.S. taxpayer's initial investment and are outside the control of the U.S. taxpayer should not be taken into account.

*Example 8:* A U.S. corporation (“USCO”) owns 50 percent of the stock of a Country X corporation (“FCO”). FCO issues a security that is treated as debt for U.S. and Country X tax purposes to a Country X resident. Two years later, the security is sold by the Country X resident to a Country Y resident. For Country Y tax purposes, the security is treated as a 10 percent equity interest in FCO and the holder is entitled to a credit for taxes paid by FCO.

Assuming that FCO is an SPV, it appears that the sale of the security to the Country Y resident results in the arrangement becoming an SPIA. This result is inappropriate, because the “arbitrage” transaction was not planned by the U.S. taxpayer and does not result in any benefit to the U.S. taxpayer.

#### 5. Unrelated Counterparty

The fifth condition for SPIA treatment is that there be an unrelated counterparty. The unrelated counterparty must be treated for foreign tax purposes as owning directly or indirectly 10 percent or more of the equity of the SPV or as acquiring 20 percent or more by value of the assets of the SPV. For this purpose, two persons are treated as related if one person directly or indirectly owns stock (or an equity interest) representing more than 50 percent of the total equity value of the other person, or the

same person directly or indirectly owns stock (or an equity interest) representing more than 50 percent of the total value of both persons.<sup>44</sup>

We believe that, absent modification of the All-or-Nothing Rule, the 10 percent and 20 percent thresholds are too low for purposes of identifying arrangements the primary purpose of which is to produce arbitrage benefits and that a 50 percent threshold would be more appropriate. If the All-or-Nothing Rule were eliminated, we believe that the lower thresholds in the proposed regulations would be appropriate.

It is not clear why the proposed regulations require that a single foreign counterparty (or group of related foreign counterparties) own the requisite 10 percent or 20 percent interest. It may well be that in most cases no foreign tax benefits are available to owners of smaller interests or that the requisite financial engineering is not justified absent a single counterparty with a lot at stake. Nonetheless, we believe that interests of all foreign parties deriving foreign tax benefits should be aggregated for purposes of the ownership threshold, even if the foreign parties are unrelated to one another. Under the proposed regulations, an arrangement which results in foreign tax benefits to ten unrelated foreign parties, each of which is treated as owning a 9 percent interest in the SPV for foreign tax purposes, would not be an SPIA. This result is not justifiable on policy grounds. The benefit to the U.S. taxpayer depends on the total percentage interest of the foreign counterparties, not the number of foreign counterparties.

We also believe that the related party definition is too broad for purposes of determining whether a foreign counterparty is unrelated to the U.S. taxpayer. Where

---

44. Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(C)(6).

the foreign counterparty is the owner of the U.S. person or the common owner of the U.S. person and the foreign counterparty is itself a foreign person, the potential for U.S. tax avoidance is no different from a transaction involving unrelated parties. By contrast, where the U.S. taxpayer owns the foreign counterparty or the person controlling both parties is itself subject to U.S. tax, the reduction in the foreign counterparty's tax liability generally will ultimately result in reduced foreign tax credits being available for U.S. tax purposes. Accordingly, we recommend that a U.S. person and a foreign counterparty be treated as related only if the U.S. person directly or indirectly owns a controlling interest in the foreign counterparty or the two parties are directly or indirectly controlled by another U.S. person.

On a technical level, we do not understand why the 20 percent interest in assets test is defined by reference to the foreign counterparty "acquiring" rather than "owning" the interest in the SPV's assets for foreign tax purposes. Finally, because the relevant inquiry is whether the foreign counterparty is treated as owning a threshold interest for foreign tax purposes, the proposed regulations should be amended to clarify that direct or indirect ownership is determined by reference to foreign rather than U.S. tax principles.

6. Inconsistent Treatment

The sixth condition for SPIA treatment is that the U.S. and an "applicable foreign country" provide inconsistent tax treatment of the transaction. An applicable foreign country is defined as a country in which the SPV pays (or is deemed to pay) taxes

or which confers a tax benefit to the foreign counterparty.<sup>45</sup> One or more of the following aspects of the transaction must be treated differently, and the U.S. tax treatment of such aspect or aspects must “materially” affect the amount of foreign tax credits otherwise available to or the amount of income recognized by the U.S. party:

- (i) Classification of an entity as a taxable or as a pass-through entity.
- (ii) Characterization of an instrument as equity, debt, or disregarded.
- (iii) The proportion of the equity of the SPV, or of an entity that directly or indirectly owns the SPV, treated as owned by the U.S. party and the foreign counterparty.
- (iv) The amount of taxable income of the SPV for one or more taxable years.

This condition should be narrowed to focus on different definitions of ownership for U.S. and foreign tax purposes and differences in the amount of the SPV’s taxable income that result from different characterizations of instruments issued by the SPV. Our concern with the condition as set forth in the proposed regulations can be illustrated by the following example:

*Example 9:* Each of USP, a U.S. corporation, and FC, a Country X corporation, is treated for both U.S. and Country X tax purposes as owning 50 percent of the equity of an SPV organized in Country X. SPV is treated as a taxable entity for Country X tax purposes and as a partnership for U.S. tax purposes. FC is exempt from Country X tax on dividends received from the SPV under Country X’s imputation system.

It appears that the inconsistent treatment condition is met in Example 9, since treatment of the SPV as a partnership for U.S. tax purposes affects the amount of income recognized by and foreign tax credits available to USP. It is also likely that the

---

45. Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(C)(I).



other five conditions will be met. However, it is difficult to see any potential for tax abuse.<sup>46</sup>

In addition, the inconsistent treatment should be relevant only if the foreign tax treatment results in a material decrease in the U.S. taxpayer's income from the transaction or an increase in its foreign tax credits relative to what would be recognized absent the inconsistent treatment. For example, in Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(D) *Example 4*, the U.S. taxpayer owns an instrument issued by the SPV that is treated as debt for foreign tax purposes but equity for U.S. tax purposes. The SPV's ability to deduct the "interest" paid to the U.S. taxpayer reduces foreign tax liability and therefore tends to dilute rather than to enhance the available foreign tax credit relative to what would be available if the instrument were treated as equity for foreign tax purposes. This does not present the type of concern that the SPIA rules are intended to address.<sup>47</sup>

E. Consequences of SPIA Classification

1. Amount of Disallowed Foreign Tax Credits

If an arrangement is classified as an SPIA, no payments of foreign taxes attributable to the arrangement are eligible for the foreign tax credit. A foreign payment is attributable to an SPIA if it is paid by the SPV (including as a result of treatment of a lower-tier entity as a branch or pass-through entity for foreign tax purposes). An attributable foreign payment also includes a payment with respect to income required to

---

46. Another way to address this issue would be to specify that the inconsistent treatment must be reasonably likely to affect the U.S. person's total foreign tax credits or taxable income over the life of the transaction rather than in a given year.

47. As discussed at IV.D.4, above, the real issues posed by this example are addressed by the proposed amendments to the technical taxpayer rules.

be taken into account by the owner of an entity for foreign tax purposes. Finally, a foreign payment attributable to an arrangement includes a foreign tax payable by a lower-tier entity that is treated as a disregarded entity or pass-through entity for U.S. tax purposes.<sup>48</sup>

We believe that the All-or-Nothing Rule is excessively punitive. The extent of our concern with the All-or-Nothing Rule is to some degree affected by the breadth of the SPIA definition. If the SPIA definition is sufficiently narrow so as to apply only to contrived, purely tax-driven transactions, taxpayers will avoid engaging in SPIAs and the All-or-Nothing Rule becomes less relevant.

Regardless of the breadth of the SPIA definition, however, the All-or-Nothing Rule is particularly troubling in situations in which the U.S. taxpayer has no control over the activities that result in SPIA status, as illustrated by the following example:

*Example 10:* A U.S. corporation (“USCO”) owns 10 percent of the stock of a Country X corporation (“FCO”). The remaining stock in FCO is owned by unrelated foreign parties. Assume that FCO is an SPV, but that there is no inconsistency in U.S. and foreign tax treatment. If FCO subsequently issues to a Country Y resident a hybrid instrument, treated as debt for U.S. and Country X tax purposes, but as a 10 percent equity interest for Country Y tax purposes which entitles the Country Y resident to a foreign tax credit for taxes paid by FCO, it appears that the arrangement will become an SPIA.<sup>49</sup>

---

48. Prop. Treas. Reg. § 1.901-2(e)(5)(iv)(A), (B) (I)(ii).

49. If Country Y tax principles applied for U.S. tax purposes, USCO would not be a 10 percent shareholder eligible for this Section 902 credit.

In Example 10, it is questionable whether any foreign tax credits otherwise available to USCO should be denied.<sup>50</sup> Denial of all credits is completely unreasonable.

We recommend that credits be disallowed only to the extent necessary to avoid duplicative benefits (thus disallowing, for example, credits for foreign taxes that are creditable by foreign counterparties, as well as foreign taxes attributable to income of an SPV that when distributed to a foreign counterparty is eligible for a participation exemption). Because of the potential difficulty in calculating the amount of credits that should be disallowed, it is appropriate to put the burden on the taxpayer of proving the amount of credits that should be allowed under this standard.

The regulations should include examples illustrating the application of our suggested standard in order to clarify its application. For example, in the case of an SPIA involving a repurchase transaction that results in a foreign counterparty being treated for foreign tax purposes as owning stock that is treated as owned by the U.S. taxpayer for U.S. tax purposes, the allowable credits should be limited to those that would be available if the U.S. taxpayer did not own the stock subject to the repurchase transaction.<sup>51</sup> In the case of an SPIA involving a hybrid instrument treated as debt for U.S. tax purposes and equity under the laws of the SPV's jurisdiction, the allowable credit should be calculated as if the instrument were treated as debt for foreign tax purposes with a resulting reduction in the SPV's foreign tax liability.

---

50. This example poses issues similar to those posed by Example 8.

51. For example, if the U.S. taxpayer engages in a repurchase transaction involving 80 percent of the SPV's stock, foreign tax credits would be limited to those that would be available if the U.S. taxpayer owned 20 percent of the stock of the SPV.

## 2. Treatment of Non-Creditable Taxes

The proposed regulations are unclear as to the treatment of foreign taxes that are attributable to an SPIA and therefore not creditable. Because the taxes do represent an expense, they should be deductible where the SPV is treated as a pass-through entity for U.S. tax purposes. If the SPV is treated as a foreign corporation for U.S. tax purposes, the foreign tax payments should reduce the SPV's earnings and profits and, to the extent attributable to subpart F income of the SPV, reduce subpart F inclusions.

## V. EFFECTIVE DATES

Both the “deeming” rule applicable to U.S.-owned foreign entities and the SPIA rules are proposed to be effective “for foreign taxes paid or accrued during taxable years of the taxpayer ending on or after the date on which these regulations are published as final regulations in the Federal Register.”<sup>52</sup> By contrast, the changes to the “technical taxpayer” rules, which were proposed on August 4, 2006, would be effective “for foreign taxes paid or accrued during taxable years beginning on or after January 1, 2007.”<sup>53</sup>

The proposed effective date results in substantial retroactivity, especially if the regulations are finalized in 2007. In the case of a calendar year taxpayer, for example, the SPIA rules would apply to taxes imposed on income earned three months before the regulations were even proposed. This is exacerbated by the IRS position that foreign taxes do not accrue until the end of the foreign taxpayer's year as determined for

---

52. Prop. Treas. Reg. § 1.901-2(h).

53. REG-124152-06, 71 Fed. Reg. 44240 (Aug. 4, 2006).

purposes of the relevant foreign tax.<sup>54</sup> If, for example, an SPV has a March 31 fiscal year for foreign tax purposes and a calendar year for U.S. tax purposes, it appears that the proposed regulations would apply to taxes paid with respect to the SPV's income earned on and after April 1, 2006.

The proposed regulations represent a significant modification of present law. In addition, the SPIA rules in their proposed form go beyond transactions that are clearly abusive and in our view should be significantly modified prior to finalization. We believe a prospective effective date would be more appropriate and that the final rules should apply only to taxes paid or accrued in years beginning after final regulations are issued.

Second, statements by IRS officials have raised the question of whether the relevant taxable year for purposes of the effective date is the year of the SPV in which it pays or accrues the taxes or the year of the U.S. taxpayer in which it claims the foreign tax credits.<sup>55</sup> Under the current regulations, the taxpayer is the person on whom foreign law imposes the liability.<sup>56</sup> This is also the rule articulated in the proposed "technical taxpayer" regulations.<sup>57</sup> Looking to the taxable year of the U.S. taxpayer raises the possibility that if a CFC incurs taxes in 2000 and pays a dividend out of the underlying earnings in 2008 that would normally produce a Section 902 credit, the taxes paid in 2000

---

54. Rev. Rul. 61-93, 1961-1 C.B. 390.

55. *See, e.g., Government Officials Discuss Foreign Tax Credit Generator Regs*, in TAX NOTES TODAY, 2007 TNT 95-3 (May 16, 2007).

56. Treas. Reg. § 1.901-2(f)(1).

57. Prop. Treas. Reg. § 1.901-2(f)(1)(i).

would be subject to the proposed regulations. We believe that the taxable period that is relevant should be the tax year of the foreign entity (as determined for U.S. tax purposes) in which it pays the foreign taxes, rather than that of the U.S. taxpayer which ultimately claims the credits. A different rule would be inequitable, especially in view of the operation of the deemed foreign tax credit system, which requires maintenance of pools going back to 1987.

Similar concerns with respect to the retroactivity inherent in the effective date for the proposed regulations are also applicable in the context of the “deeming rules” of Prop. Treas. Reg. § 1.901-2(e)(5)(iii), to the extent that they are intended to imply that application of foreign group relief regimes may result in future tax payments being noncompulsory. This is because a foreign corporation may be required to pay a foreign tax in a future year as a result of the surrender of a loss in a taxable year prior to the issuance of the proposed regulations. As a result, the proposed regulations potentially have the effect of penalizing taxpayers for actions that may have been taken years before they were issued. Accordingly, we believe that any rule disallowing credits under Prop. Treas. Reg. § 1.901-2(e)(5)(iii) should apply only with respect to the surrender of a loss incurred in a taxable year beginning after final regulations are published.