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International Tax Alert

Subject:

Proposed FTC Regulations

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On March 29, 2007, the Internal Revenue Service issued proposed regulations (REG-156779-06) to stop certain abusive cross-border borrowing, lending and asset holding transactions intended to artificially generate foreign tax credits. The rules essentially treat foreign tax payments attributable to these arrangements as "noncompulsory" tax payments that are not eligible for the foreign tax credit. In determining whether a tax payment is "noncompulsory," the rules would treat as a single taxpayer all foreign entities with respect to which a U.S. person has a direct or indirect interest of 80% or more.

Affecting

U.S. taxpayers receiving foreign tax credits through the use of foreign entities.

Background

Section 901 of the Internal Revenue Code ("IRC") allows taxpayers to claim a credit for income, war profits, and excess taxes paid or accrued (or deemed paid) during the taxable year to any foreign country or to any possession of the United States.

To qualify for a U.S. foreign tax credit, a payment to a government must meet three requirements under Treas. Reg. Section 1.901-2(a): (1) the payment must be a "tax"; (2) the tax must be paid or accrued to a foreign country or a U.S. possession; and (3) the tax must be an income, war profits, or excess profits tax (or must be paid in lieu of such a tax).

Section 1.901-2(a) of the regulations defines a tax as a compulsory payment pursuant to the authority of a foreign country to impose taxes, and further provides that a tax is an income, war profits, or excess profits tax if the predominant character of the tax is that of the income tax in the U.S. sense.

The Current Regulations

A tax by its very nature must be a compulsory payment. Therefore, if a payment is noncompulsory, the taxpayer is not eligible for any U.S. foreign tax credit with respect to such payment.

Out of concern over taxpayers that may have paid too much in foreign taxes, Section 1.901-2(e)(5) of the regulations provides that payments in excess of the true tax liability under foreign law are noncompulsory payments and thus may not generate any U.S. foreign tax credit.

The regulations provide that the amount paid does not exceed the taxpayer's liability if two conditions are satisfied. First, the taxpayer is required to determine the amount paid in a manner consistent with a reasonable interpretation and application of the foreign law (including tax treaties) to reduce over time the taxpayer's reasonably expected foreign tax liability. Second, the taxpayer must exhaust all effective and practical remedies, including invocation of competent authority procedures under tax treaties, to reduce over time the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment).

Section 1.901-2(e)(5) further provides that the taxpayer does not have to reduce foreign taxes by changing the form of doing business or the form of any transaction. Further, the taxpayer may make elections that shift foreign taxes to different years.

Certain commentators have expressed concern that in cases where one foreign entity directly or indirectly owned by a U.S. person transfers, pursuant to a group relief type regime, a net loss to another foreign entity, foreign taxes paid by the transferor in a subsequent tax year might not be compulsory payments to the extent the transferor could have reduced its liability for those foreign taxes had it chosen not to transfer the net loss in the prior year. This concern arises because the current regulations apply on a taxpayer-by-taxpayer basis, obligating each taxpayer to minimize its liability for foreign taxes over time, even though the net effect of the loss surrender may be to minimize the amount of foreign taxes paid in the aggregate by the controlled group over time.

Further, the IRS and Treasury Department have become aware that certain U.S. taxpayers are engaging in highly structured transactions with foreign counterparties in order to generate foreign tax credits. These transactions are intentionally structured to create a foreign tax liability when, removed from the elaborately engineered structure, the basic underlying business transaction generally would result in significantly less, or even no, foreign taxes.

The Proposed Revisions to the Regulations

The proposed regulations address the application of Section 1.901-2(e)(5) in cases where a U.S. person directly or indirectly owns one or more foreign entities and in cases in which a U.S. person is a party to a highly structured passive investment arrangement.

The proposed regulations treat as a single taxpayer for purposes of Section 1.901-2(e)(5) all foreign entities with respect to which a U.S. person has a direct or indirect interest of 80% or more. For this purpose, an interest of 80% or more means stock possessing 80% or more of the vote and value (in the case of a foreign corporation) or an interest representing 80% or more of the income (in the case of non-corporate foreign entities).

The proposed regulations treat foreign payments attributable to highly structured passive investment arrangements as noncompulsory payments under Section 1.901-2(e)(5) and, thus, disallow foreign tax credits for such amounts. Such structured arrangements can be grouped into three general categories: (1) U.S. lender transactions, (2) U.S. borrower transactions and (3) asset holding transactions.

Under the lending transaction, a U.S. taxpayer lends money indirectly to a foreign borrower through a foreign special-purpose entity, resulting in cash distributions based on equity instead of interest income. The taxpayer also claims foreign tax credits for foreign taxes paid by the special-purpose entity thereby eliminating all or substantially all of the U.S. tax the U.S. person would otherwise owe on its interest income if the U.S. person were to loan the funds directly to a foreign person.

Under the borrowing transaction, the U.S. taxpayer borrows money in the financing transaction through means of a special purpose vehicle. The U.S. borrower acquires a direct or indirect interest in the special purpose vehicle and asserts that the interest is equity for U.S. tax purposes. The U.S. borrower claims credits for taxes paid on the income in the special purpose vehicle.

Under the asset holding transaction, a U.S. person that owns income producing assets moves them to a special purpose vehicle in a foreign taxing jurisdiction that subjects the income stream to foreign taxes. With the use of this arrangement, the U.S taxpayer then obtains foreign tax credits for the taxes paid to reduce its U.S. tax liability.

A common feature of all these arrangements is that a U.S. person and a foreign counterparty share the economic cost of the foreign taxes claimed as credits by the U.S. person which creates 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. The end result is an erosion of the U.S. tax base in a manner that is not consistent with the purposes of the foreign tax credit provisions.

The regulations are not designed to affect ordinary borrowing, lending, or asset holding transactions.

To narrow the application, the proposed rules set out six specific requirements an arrangement must meet in order to have its foreign tax credits disallowed:

1. The deal must use an entity that earns substantially all of its gross income from passive investment. Substantially all of the entity's assets also must derive from passive investment. Under this requirement, a purported foreign tax payment must be attributable to income of this entity.
2. The U.S. taxpayer would be eligible to claim a credit under IRC Section 901 (including a credit for foreign taxes deemed paid under Section 902 or 960) for all or a portion of the payment if that payment had been tax paid.
3. The foreign payments must be "substantially greater" than the amount of credits that the U.S. party would reasonably expect to claim if that party directly owned its proportionate share of the assets;
4. The arrangement must be structured in such a way that it results in a foreign tax benefit for a participant unrelated to the U.S. taxpayer;
5. The unrelated party must directly or indirectly own more than 10% of the entity under the laws of a foreign country, or must acquire 20% or more of the assets of the entity under those foreign laws, and;
6. The U.S. and an applicable foreign country must treat the arrangement differently under their respective tax laws.

The regulations 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 the final regulations are published in the Federal Register. No inference is intended regarding the U.S. tax consequences of structured passive arrangements prior to the effective date of the regulations.

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