Finalized foreign tax credit 'generator' regulations add withholding taxes

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In brief

The Treasury Department and IRS have finalized (2013 final regulations) temporary and proposed regulations issued in 2011 (2011 temporary regulations). The 2011 temporary regulations appeared alongside a set of final regulations (2011 final regulations) intended to address certain types of foreign tax credit (FTC) generator arrangements. The 2011 temporary regulations added a provision to deal with certain situations involving withholding taxes on distributions with respect to an entity covered by the 2011 final regulations.

Observation: Both the 2011 and 2013 final regulations address highly structured FTC generator transactions. Thus, the specific technical details of these regulations may not immediately concern companies that did not undertake such planning.

In detail

In general, the 2011 final regulations limit the definition of creditable foreign taxes for purposes of Section 901. The 2011 final regulations disallow FTCs for foreign taxes paid in connection with certain "structured passive investment arrangements" that the IRS views as generating US FTCs in an inappropriate manner. Those regulations disallow the credits based on treating foreign tax payments attributable to such arrangements as voluntary (non-compulsory) payments under Treas. Reg. sec. 1.901-2(e)(5).

The IRS characterizes the types of transactions addressed in these regulations as "transactions designed to artificially generate foreign tax credits." The 2011 final regulations describe in detail the categories of passive investment arrangements subject to these limitations and identify six specified conditions under which an arrangement's credits could be disallowed.

1. <u>Use of an SPV</u>: The transaction uses a "special purpose vehicle (SPV)" entity whose (i) income and assets are substantially all passive (under an expansive definition) and (ii) income is subject to taxation in a foreign country, other than a withholding tax on its owners.

   Observation: The 2013 final regulations make a very minor adjustment to the SPV definition, possibly to ensure that these rules would cover a specific structuring arrangement.

2. <u>Equity participation by the US person</u>: From a US federal income tax perspective, a US person has an equity interest in the SPV.

3. <u>Greater tax cost to the US person</u>: The tax cost to the SPV is greater than the foreign tax expense that would have been imposed on

the US investor if the US investor owned its interest in the SPV's assets directly.

4. Involvement of an unrelated foreign person: A foreign person participates in the transaction by (i) owning at least 10% of the SPV's equity (under foreign law) or (ii) acquiring, directly or indirectly, 20% of the SPV's assets.

5. Foreign tax benefit to the foreign person: The structure results in some kind of foreign tax benefit to the foreign person.

6. Tax arbitrage: The US person's FTC claim results directly from tax arbitrage between the US and another country involving (i) hybrid entities, (ii) hybrid instruments, (iii) inconsistent identity of tax ownership, or (iv) inconsistent measurement of an entity's taxable income.

The 2013 final regulations address arrangements involving a distribution from a covered foreign entity (i.e., an entity whose activities would put it in one of the above six categories) that is subject to withholding tax that could potentially be creditable in two jurisdictions.

The IRS and Treasury received no comments on the 2011 temporary regulations and consequently finalized them as originally drafted. The 2011 final regulations apply to foreign taxes considered to be paid or accrued on or after July 13, 2011, but the newly finalized provision on withholding taxes in the 2013 final regulations applies to payments made on or after September 4, 2013. (Note, however, that the 2011 temporary regulations applied similar rules effective in July 2011.)

The takeaway

The specific technical details of these regulations may not be particularly relevant to companies that did not engage in highly structured FTC generator transactions. The 2013 final regulations simply finalize the one provision added in the 2011 temporary regulations.

Companies affected by these regulations should review the impact on their global structure.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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