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Final regulations limit transactions viewed as generating foreign tax credits

In recent times, the Treasury Department and IRS have targeted certain categories of tax planning techniques, seeking to limit perceived abuses. One of those categories involves transactions sometimes termed “foreign tax credit generators,” that is, transactions or structures that the IRS and Treasury view as designed primarily to generate U.S. foreign tax credits ("FTCs") out of proportion to the economic profits earned and actual foreign taxes paid. On July 13, 2011, in T.D. 9535, Treasury and IRS finalized (in the "2011 final regulations") temporary regulations issued in 2008 (the “2008 temporary regulations”), intended to address certain types of FTC generators. The same day, in T.D. 9536, temporary regulations were issued that added a provision to deal with certain situations involving withholding taxes on distributions with respect to an entity covered by the 2011 final regulations (the "2011 temporary regulations").

Observation: Like the 2008 temporary regulations, the 2011 final regulations and 2011 temporary regulations are aimed at tax planning techniques involving primarily financial institutions, and the specific technical details may not be of as much direct concern to companies in other industry sectors. The 2011 final regulations are the latest in a series of expiring temporary regulations in the process of being finalized this year.

General Summary

The 2011 final regulations retain the basic approach and structure of the 2008 temporary regulations. In general, these regulations limit the definition of creditable foreign taxes for purposes of section 901, disallowing FTCs for foreign taxes paid in connection with certain "structured passive investment arrangements" that the IRS views as generating U.S. FTCs in an inappropriate manner. The new regulations disallow the credits based on treating foreign tax payments attributable to such arrangements as voluntary (non-compulsory) payments under Treas. Reg. §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 follow the 2008 temporary regulations in describing in detail the categories of passive investment arrangements subject to these limitations and identifying six specified conditions that potentially would subject an arrangement to the disallowance of credits. The 2011 temporary regulations address certain arrangements involving a distribution from a covered foreign entity that is subject to withholding tax which could potentially be creditable in two jurisdictions.

The 2011 final regulations are effective as of July 18, 2011, while the 2011 temporary regulations appear to be applicable to foreign tax payments made on or after July 14, 2011 (T.D. 9536 actually shows the effective date as July 14, 2014, but that might be a typographical error, as July 14, 2014 is also shown as the expiration date of the 2011 temporary regulations).

As stated in the preamble to the 2011 final regulations, the IRS intends to continue challenging arrangements viewed as FTC generators that may not be covered by these regulations under other authority, including common-law doctrines. The IRS and Treasury may also issue future regulations to address such other arrangements.

Key Points of the Regulatory Scheme

Under Treas. Reg. §1.901-2(e)(5), a taxpayer's foreign tax expense is creditable only if it is considered involuntary under criteria prescribed in Treas. Reg. §1.901-2(a): basically, that the foreign tax is computed in accordance with a reasonable interpretation of foreign law (and treaties), and the taxpayer must exhaust all reasonable avenues of relief with respect to such tax.

The 2011 final and temporary regulations follow the 2008 temporary regulations in targeting certain "structured passive investment arrangements" grouped into three general categories, all involving a U.S. person and a foreign counterparty: (1) U.S. borrower transactions, (2) U.S. lender transactions, and (3) asset holding transactions. The IRS claims that the U.S. person's FTC benefit is shared by the parties through the pricing of the arrangement.

"U.S. borrower transactions" involve a U.S. person borrowing funds indirectly from an unrelated foreign counterparty in such a way that some or all of the payments it makes are structured to be creditable foreign tax payments. "U.S. lender transactions" involve a U.S person lending funds indirectly to an unrelated foreign counterparty in such a way that payments it receives are structured to be creditable foreign tax payments. "Asset holding transactions" involve a U.S person moving an income-producing asset that it owns into a foreign taxing jurisdiction in such a way that any foreign tax payments on income produced by that asset are structured to be creditable.

The IRS views six features or "conditions" as common to all three types of arrangements, leading to the classifying of the FTC payments as voluntary and therefore not creditable:

1. Use of an SPV: The transaction uses a “special purpose vehicle (SPV)” entity whose income and assets are substantially all passive (under an expansive definition) and whose income is subject to taxation in a foreign country, other than a withholding tax on its owners.
2. Equity participation by the U.S. person: From a U.S. federal income tax perspective, a U.S. person has an equity interest in the SPV and can claim a credit for the SPV's foreign tax liability.
3. Greater tax cost to the U.S. person: The tax cost to the SPV is greater than the foreign tax expense that would have been imposed on the U.S. investor if the U.S. 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 owning at least 10 percent of the SPV’s equity (under foreign law) or by acquiring, directly or indirectly, 20 percent 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 U.S. person's FTC claim results directly from tax arbitrage between the U.S. 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.

Changes in the 2011 Final and Temporary Regulations

The 2011 final regulations include several changes, generally in response to the many comments received on the 2008 temporary regulations.

1. The language of the 2008 temporary regulations defining "passive investment income" has been amended in two ways:

(a) The 2011 final regulations provide that passive investment income does not include personal service contract income, as described in section 954(c)(1)(H).

(b) The last two sentences in Temp. Treas. Reg. §1.901-2T(e)(5)(iv)(B)(*1*)(*i*) have been deleted. Those sentences had set out in more detail the definition of passive investment income.

Observation: These changes narrow slightly the 2008 temporary regulations' expansive definition of passive investment income.

2. The 2011 final regulations provide that the assessment of the opportunity for gain and risk of loss is based on all facts and circumstances.

Observation: This facts and circumstances test may tend to blur the bright-line rule that the 2008 temporary regulations created.

3. The 2011 final regulations change the application of the holding company exception for fact patterns involving multiple counterparties or multiple U.S. parties. The new treatment fulfils the requirement that the parties must share in substantially all of the upper-tier entity's opportunity for gain and risk of loss with respect to its interest in a lower-tier entity by examining whether there is sufficient risk sharing by each of the groups comprising all U.S. parties (or person related to such U.S. parties) and all counterparties (or persons related to such counterparties). The intent of this risk-sharing requirement is to ensure that only bona fide joint ventures are eligible for the holding company exception. In addition, the modified version in the 2011 final regulations does not require that each member of the U.S. party and counterparty groups share in the underlying investment risk.

Similarly, the 2011 final regulations have modified the holding company exception to this requirement such that, where a U.S. party owns an entity interest indirectly through a chain of entities, the exception is applied beginning with the lowest-tier entity in the chain before proceeding upward. The opportunity for gain and risk of loss borne by any upper-tier entity in the chain that is a counterparty is disregarded to the extent that it is borne indirectly by a U.S. party.

Observation: These changes relax slightly the 2008 temporary regulations' approach to ensuring that joint ventures and corporate chains cannot be used to mask arrangements that these anti-abuse rules would otherwise cover.

4. The 2011 final regulations change the treatment of foreign payments attributable to the entity's share of income of a lower-tier entity that is a branch or pass-through entity under either foreign or U.S. law by removing the sentence that attributed such payments to its owner's income. Where a lower-tier entity is liable for foreign payments under foreign law, the disallowance of FTCs with respect to such taxes should turn on whether that entity itself (not its owner), is an SPV.

5. The 2011 final regulations change the "foreign tax benefit" (fourth) condition to address a comment about the treatment of counterparties with respect to certain tax benefits claimed by upper-tier entities that do not correspond to the U.S. party's share of the foreign payment. Specifically, where a U.S. party indirectly owns a non-hybrid equity interest in an SPV, a foreign tax benefit available to a foreign entity in the chain of ownership that begins with the SPV and ends with the first-tier entity in such chain does not correspond to the U.S. party's share of the foreign payment attributable to the SPV to the extent that such benefit relates to the SPV's earnings that are distributed with respect to non-hybrid equity interests in the SPV that are owned indirectly by the U.S. party for purposes of both U.S. and foreign tax law. This revision is intended to ensure that taxpayers are not triggering the foreign tax benefit condition where the U.S. and foreign investors claim only those tax benefits that are consistent with their respective investments in the arrangement, and their interests are treated as equity and owned by the same persons in both jurisdictions.

6. The 2011 final regulations modify the treatment of dual citizens or U.S. residents, who are generally subject to U.S. tax on their worldwide income, such that they will not be treated as counterparties. The rationale for this change is that any reduction in their foreign tax liability will result in a corresponding increase in U.S. tax.

7. The 2011 final regulations narrow the application of the "inconsistent treatment" (sixth) condition where an arrangement involves multiple U.S. parties, by providing that the condition applies only if a comparison with the foreign tax treatment shows that (i) the amount of income attributable to the SPV recognized for U.S. tax purposes is materially less than the amount of income that would be recognized or (2) the amount of FTCs claimed by all U.S. parties is materially greater than it would be if the foreign tax treatment controlled for U.S. tax purposes.

8. The 2011 final regulations target situations where withholding taxes imposed on distributions from the SPV may be claimed as creditable in both the United States and a foreign jurisdiction. Thus, the exception for withholding taxes imposed on payments to U.S. parties has been eliminated from Treas. Reg. §1.901-2(e)(5)(iv)(B)(*1*)(*ii*). The 2011 temporary regulations address this issue (and this issue only), providing that a foreign payment attributable to income of an entity includes a withholding tax imposed on a dividend or other distribution (including distributions made by a pass-through entity or an entity that is disregarded as an entity separate from its owner for U.S. tax purposes) with respect to the equity of the entity.

Observation: Unlike most of the modifications in the 2011 final regulations, this change tightens the treatment in the 2008 temporary regulations, recognizing that some taxpayers could get a double benefit from FTCs claimed in two jurisdictions on the same withholding tax payment.

9. The 2011 final regulations add two examples that illustrate changes from the 2008 temporary regulations. Example 8 illustrates the application of the holding company exception when there is more than one U.S. party or more than one counterparty. Example 12 illustrates the application of the revised foreign tax benefit condition to a tiered holding company structure. Other modifications were also made to examples in order to reflect comments received and other changes to the regulations.

Insight: The 2011 final and temporary regulations complete the profound shift in the approach taken by the IRS starting in 2007 towards limiting perceived abuses regarding FTC utilization. Past efforts (largely unsuccessful), such as the issuance of Notice 98-5 and litigation in cases such as *ACM Partnership*, *Compaq*, or *IES*, had focused on subjective issues such as business purpose or economic substance. The 2011 final and temporary regulations have tempered the bright line against which the 2008 temporary regulations measured passive investment arrangements, but the form of a transaction is now permanently established as a crucial factor in determining whether a foreign tax is voluntary. However, the impact of these regulations is still limited to the types of transactions targeted here, and is still primarily of concern to financial institutions.

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