Foreign Tax Credit Arbitrage

eric silver, University of Miami
FOREIGN TAX CREDIT ARBITRAGE:

Proposed Regulation Section 1.901-2(e)

ERIC SILVER
I. Introduction
   A. Tax Credits
   B. Arbitrage
   C. Structured Passive Investments
   D. Foreign Tax Credit Arbitrage & Structured Passive Investments

II. The Transaction
   1. U.S. Borrower Transactions
   2. U.S. Lender Transactions
   3. Asset Holding Transactions

III. American Jurisprudence
   A. Biddle
   B. Continental Illinois Corp. v. Commissioner
   C. Xerox v. United States
   D. Notice 98-5
   E. Old Colony Trust Co. v. Comm'rn

IV. Proposed Regulation 901-2(e)(5)(iv)(B)
    A. Six Conditions of Impropriety
    B. Results Under the Proposed Regulation
       i. U.S. Borrower Transactions
       ii. U.S. Lender Transactions
       iii. Asset Holding Transactions

V. Proposed Regulation 901-2(e)(5)(iv)(B)
   A. Sheppard
   B. Dolan
   C. Wells

VI. Conclusion
Section I of this paper will describe the type of structured passive investment targeted by the proposed regulations and their intended tax benefits/burdens to the parties and jurisdictions involved. Section II will analyze the development of the current United States tax law on the subject of foreign tax credit arbitrage and the nature of compulsory payments to foreign jurisdictions. Section III will discuss the proposed regulations and their intended impact on the structured finance transactions contemplated within. Finally, Section IV will offer a critical analysis of the proposed regulation including an argument for a much broader alternative solution. This paper does take a position consistent with many tax analysts that the proposed regulations’ narrow tailored answer is ultimately an inadequate solution to the problem of international arbitrage transactions generating improper foreign tax credits.

I. INTRODUCTION:

A – TAX CREDITS

Within the sophisticated world of international finance, there exists an inherent tension in characterizing particular tax strategies as either savvy investments or imprudent tax avoidance. At the center of this struggle are the proposed amendments to regulation section 901 of the Internal Revenue Code. Both the Internal Revenue Service (the IRS) and the Treasury Department claim that the proposed regulations will guide tax strategists in determining the appropriate amount of domestic and foreign taxes paid and the claiming of foreign tax credits. More specifically, the updates to the legislation concern transactions involving U.S.-owned foreign entities and certain structured passive investment agreements. For purposes of this paper, we will examine the proposed legislation’s attempt to deal with the tax deficiency created by multi-jurisdictional structured finance.
This paper explores a concept known as foreign tax credit arbitrage. Section 901 of the Internal Revenue Code permits a domestic taxpayer (either U.S. person or entity) to claim a foreign tax credit for tax paid to any foreign jurisdiction.\textsuperscript{1} That is to say that when Company A from the United States transacts business in Jurisdiction B, Company A may be responsible for income tax on income earned in both the United States and Jurisdiction B. The purpose of the tax code is to promote fair and efficient accounting of taxes; therefore, it is against the principles of income taxation for Company A to have to pay tax on the same income in both jurisdictions.\textsuperscript{2} To this end, the IRS (the bureau of the Department of Treasury responsible for the collection and assessment of all taxes imposed by law) permits Company A to claim a credit for the income tax paid to a foreign jurisdiction. These credits have become a valuable commodity in international transactions; so much so that businesses, and in particular banks, have become accustomed to structuring transactions in such a way as to artificially generate these credits. The specifics and, more importantly, the implications of these transactions will be discussed later on, but for now it is important to note that the practice of artificially generating foreign tax credits through structured passive investment agreements is known as foreign tax credit arbitrage, and that the IRS considers some of these transactions as abusive of the foreign tax credit regime.

**B - Arbitrage**

Arbitrage is a financial term used to reflect a transaction, or series of transactions, in which an investor/s, whether individual or institutional, seeks to take advantage of minor pricing discrepancies between markets or financial instruments. The principles of free markets state that a market must always be in equilibrium. However, in practice, there are imbalances all the time; nevertheless, they are usually minor and fleeting. A typical situation in which arbitrage routinely

\textsuperscript{1} See IRC § 1.901-2.
\textsuperscript{2} See Proposed IRC § 1.901-2(e) Preamble.
arises is in the foreign exchange markets. For instance, an investor in Japan may be getting a very minor pricing difference for a U.S. exchange rate than, say, an investor in France in USD for Euros. If the Japanese investor, or even the French for that matter, is aware of the pricing difference and chooses to do so, it can use the principles of arbitrage to exploit the discrepancy and turn a risk-free profit. However, as stated earlier, the difference in price tends to be miniscule and temporary, and often there are transactional costs associated with trading foreign exchange (or any financial transaction for that matter). Therefore, in order for the arbitrageur to see any kind of meaningful return on its investment, the entity must either repeat the transaction a number of times, or highly leverage its investment. Given the fleeting nature of the pricing discrepancy, repeating the transaction seems unlikely and tedious, whereas leveraging the transaction is a much simpler solution to higher returns. In the world of foreign tax credit arbitrage, the inconsistent treatment the jurisdictions afford certain aspects of the transaction is what creates profitability.

**C – STRUCTURED PASSIVE INVESTMENTS**

Structured passive investments, also known as structured finance, are merely hyper-complex approaches to a simple lending transaction. In order to properly illuminate the economic effects of their more complex counterparts, let us first discuss the financial characteristics of a simple loan. When a borrower receives funds from a lender, it promises to pay back the principle (the amount of money borrowed) plus some interest (determined by multiplying the principle by a certain rate to be determined by the parties to the transaction) in periodic payments. According to the principles of accounting, the amount paid will consist of some combination of principle and interest. This process is called amortization and has a real
Typically, the large portion of the first payments on a loan agreement is designated as interest, with the repayment of principle designated for later in the life of the loan.4

**D – FOREIGN TAX CREDIT ARBITRAGE & STRUCTURED FINANCE**

In the world of foreign tax credit arbitrage, domestic banks seek loans from foreign banks because they believe the cost of borrowing will be cheaper abroad rather than in the United States. While this was even more evident at the turn of the last century, the emergence of globalization and the free flow of information due to developing technologies have limited opportunistic banks’ capabilities to gather foreign funds at unusually low rates. Thus, in order to achieve lower rates, banks have recently employed highly leveraged structured passive investments that create minor taxation discrepancies which result in major profits to both parties and the foreign jurisdiction.

The effect of the foreign tax credit arbitrage scheme is to expose gaps in the foreign tax credit basket through structured finance. Because of the complex nature of the transactions themselves, it has been hypothesized by leading scholars in the field that the primary American customers for such transactions are financial intermediaries.5 Based on an estimate quoted by tax expert Lee Sheppard, “11 such transactions, represent[ ] a combined U.S. tax deficiency of $3.5 billion…”6 This, of course, is a number that causes great concern on behalf of the Treasury

---

3 As part of this general public policy, the tax code provides that while principle payments are nondeductible, interest payments are an above the line deduction from taxable income. Thus, borrowers are given an artificial discount on their cost of funds. The mix of principle and interest in any payment is determined by an amortization schedule.

4 This is probably because the loan is a secured transaction, meaning that the principle of the loan is secured by some sort of property. With loans defaulting at a higher rate over time, the lenders are primarily concerned with getting their interest payments (or profits) early on while the borrower is solvent. This also has obvious implications in bankruptcy given the tenuous nature of a large loan secured by over-encumbered assets.


6 *Id.* at 4-5.
Department, and according to Sheppard, “it is only the tip of the iceberg.”\(^7\) It is no wonder the IRS has made foreign tax credit arbitrage a top priority this year. However, due to an overwhelmingly unfavorable response to the proposed legislation amongst tax experts and analysts, the IRS and the Treasury Department have recently cast doubt on the effective date of the proposed regulations.\(^8\) Notice 2007-95 will postpone the effective date of the proposed regulations indefinitely, and to some extent limit its scope. From the language of the notice, it is ambiguous what the final regulations will look like and when they will be published for additional commentary.

II. THE TRANSACTIONS:

Structured Passive Investments

There are typically three types of transactions in which a United States bank will attempt to limit its foreign and domestic tax liability through the use of structured passive investment arrangements. They are, in no particular order, 1) U.S. Borrower Transactions, 2) U.S. Lender Transactions, and 3) Asset Holding Transactions.\(^9\) The following paragraphs will describe the transactions in some detail and are intended to give the reader an overview of the types of transactions targeted by the IRS in its proposed regulations.

1. U.S. Borrower Transactions

In a typical U.S. borrower transaction, a U.S. bank, or other domestic entity, seeks funds from a foreign bank, or other foreign lender. These funds are paid in accordance with the normal loan terms discussed \textit{supra} with the foreign lender subject to foreign tax on its interest income.

\(^7\) \textit{Id.} at 5.

\(^8\) \textit{See} Notice 2007-95, 2007 TNT 224-5 (2007) (postponing the effective date of the proposed regulations and casting doubt as to the implications of the intended effects in certain circumstances).

\(^9\) \textit{See} Proposed IRC § 1.901-2(e) Preamble.
However, under a structured finance agreement, the U.S. borrower sets up a special purpose vehicle (SPV) in order to indirectly acquire funds from a foreign lender. Example 1 of Section 901-2(e)(5)(iv) illustrates a common U.S. borrower fact pattern.\(^{10}\)

The key to this fact sequence is the repo agreement between the SPV and the foreign lender. “In a sale and repurchase (repo) agreement, the borrower/seller transfers securities to a lender/buyer, subject to the latter’s right to require the former to repurchase the securities at any time at the price paid by the latter.”\(^{11}\) Under such an agreement, both the domestic corporation and the foreign lender are treated as owners of the same shares of SPV stock.\(^{12}\) Structured finance also employs a “broken repo”. Under the terms of a broken repo, “the lender sells the collateral. Selling is common. The standard repo agreement only requires delivery of equivalent collateral by the lender.”\(^{13}\)

---

\(^{10}\) Proposed IRC § 1.901-2(e)(5)(iv) Example 1:

Facts. A domestic corporation (USP) forms a country M corporation (Newco), contributing $1.5 billion in exchange for 100 percent of the stock of Newco. Newco, in turn, loans the $1.5billion to a second country M corporation (FSub) wholly owned by USP. FSub is engaged in the active conduct of manufacturing and selling widgets and derives more than 50 percent of its gross income from such business. USP then sells its entire interest in Newco to a country M corporation (FP) for the original purchase price of $1.5 billion, subject to an obligation to repurchase the interest in five years for $1.5 billion. The sale has the effect of transferring ownership of the Newco stock to FP for country M tax purposes. The sale-repurchase transaction is structured in a way that qualifies as a collateralized loan for U.S. tax purposes. Therefore, USP remains the owner of the Newco stock for U.S. tax purposes. In year 1, FSub pays Newco $120 million of interest. Newco pays $36 million to country M with respect to such interest income and distributes the remaining $ 84 million to FP. Under country M law, the $ 84 million distribution is excluded from FP's income. FP is not related to USP within the meaning of paragraph (e)(5)(iv)(C)(6) of this section. Under an income tax treaty between country M and the U.S., country M does not impose country M tax on interest received by U.S. residents from sources in country M.

\(^{11}\) Sheppard, Arbitrage, supra note 5, at 4; cf William, Chip, Are Repos Really Loans?, 2002 TNT 93-28, 2 (2002) (“For federal income tax purposes, the Internal Revenue Service has long held that the sales proceeds from a repo are really a loan from the purchaser to the seller (so that the repurchase price differential is interest income to the purchaser and interest expense to the seller) and the transferred security is really collateral (so that the seller remains the owner of the security and of any interest or dividends paid on the security). Few tax advisers would dispute these longstanding holdings. Indeed, the ability to explain how a repo works, and the knowledge that it is taxed as a loan rather than a sale, demonstrates the adviser's tax sophistication.”).

\(^{12}\) See Sheppard, supra note 5, at 4.

\(^{13}\) Id.
The repo agreement allows the U.S. borrower to assert legal title to the SPV for U.S. tax purposes by characterizing the transaction as a secured borrowing. Under the old statutory regime, the structure enables the US borrower to classify the distributions from the SPV as dividend income and also claim credits for the taxes paid by SPV to the foreign jurisdiction. The net result in year 1 would lead to the U.S. borrower and its subsidiary to claim a $36 million foreign tax credit for taxes paid to foreign jurisdiction by the SPV and $84 million interest expense deduction as a result of its obligations to the SPV and foreign counterparty.

The foreign counterparty is willing to submit to the charade of structured finance because it is receiving a significantly higher after-foreign tax interest rate than it would receive on a direct loan. On the flip side of the transaction, the U.S. borrower has “converted interest expense into creditable foreign tax payments.” In addition, the foreign jurisdiction is also pleased because the taxes paid by SPV under the terms of the structured finance are higher than it would receive had the loan been directly from the foreign counterparty.

2. U.S. Lender Transactions

Under a U.S. lender transaction, a foreign bank, or other foreign entity, will look to a U.S. bank or other lending institution for cheaper funds than it is finding in its own jurisdiction. A direct loan would result in the United States lender receiving taxable interest income.

Just as the U.S. borrower transaction sought to convert interest expenses into creditable foreign tax payments, the structured finance approach to U.S. lender transactions seeks to

---

14 See Proposed IRC § 1.901-2(e)(5) Preamble at 5.
15 See id.
16 See id.
17 See id.
18 Id.
19 See id.
eliminate all, or substantially all of the U.S. tax owed on income through foreign tax credits.

Example 4 of Section 901-2(e)(5)(iv) illustrates a common U.S. lender fact pattern.\textsuperscript{20}

The key to this transaction is the treatment the U.S. lender affords its own interest in the SPV. Here, the U.S. lender treats its interest in the SPV as equity for U.S. tax purposes and debt for foreign tax purposes.\textsuperscript{21} This conflicting characterization of the same interest across jurisdictions entitles the U.S. lender to a $48 million foreign tax credit.\textsuperscript{22} Since the foreign counterparty shifts all of its income to the SPV and is treated as 100 percent equity owner for foreign tax purposes, it is entitled to $44 million in net deductions for foreign tax purposes.\textsuperscript{23}

Just as the U.S. borrower transactions, all parties but the United States Treasury Department benefit from this transaction. The United States lender receives a higher after-U.S. tax interest on its loan to the foreign party. The foreign borrower receives finds

\textsuperscript{20} Proposed IRC § 901-2(e)(5)(iv) Example 4:

\textit{Facts.} (A) A country X corporation (foreign bank) contributes $2 billion to a newly-formed country X corporation (Newco) in exchange for 100 percent of Newco's common stock. A U.S. bank (USB) contributes $1 billion to Newco in exchange for securities that are treated as stock of Newco for U.S. tax purposes and debt of Newco for country X tax purposes. The securities represent 10 percent of the total voting power of Newco. Newco contributes the entire $3 billion to a newly-formed country X entity (RH) in exchange for 99 percent of RH's equity. Foreign bank owns the remaining 1 percent of RH. RH is treated as a corporation for U.S. tax purposes and a partnership for country X tax purposes. RH loans the entire $3 billion it receives from Newco to foreign bank in exchange for a note that pays interest currently and a zero-coupon note. Under an income tax treaty between country X and the U.S., country X does not impose country X tax on interest received by U.S. residents from sources in country X. Country X does not impose tax on dividend payments between country X corporations. USB and the foreign bank are not related within the meaning of paragraph (e)(5)(iv)(C)(6) of this section.

(B) In year 1, foreign bank pays RH $92 million of interest and accrues $113 million of interest on the zero-coupon note. RH distributes the $92 million of cash it receives to Newco. Newco distributes $44 million to USB. Because RH is a partnership for country X purposes, Newco is required to report for country X purposes 99 percent ($203 million) of the income recognized by RH. Newco is entitled to interest deductions of $44 million for distributions to USB on the securities for country X tax purposes and, thus, has $159 million of net income for country X tax purposes. Newco makes a payment to country X of $48 million with respect to its net income. For U.S. tax purposes, Newco's post-1986 undistributed earnings pool for year 1 is $44 million ($92 million - $48 million). For country X tax purposes, foreign bank is entitled to interest expense deductions of $205 million.

\textsuperscript{21} See Proposed IRC § 901-2(e)(5) Preamble at 6-7.

\textsuperscript{22} See id.

\textsuperscript{23} See id.
the financing it was looking for at a cheaper rate than on a direct loan. And the foreign jurisdiction, as a result of the structured financing, receives more taxes than it would have under a direct loan because the foreign tax deduction claimed by the foreign borrower is less than the interest deduction would have been.\textsuperscript{24}

3. Asset Holding Transactions

Asset holding transactions differ from the lending transactions discussed supra in that there is no loan involved in these transactions. Instead, these structured transactions involve a transfer of assets from the United States to a foreign jurisdiction. Normally, a straight transfer would have zero net tax effect because the U.S. entity would claim foreign tax credits for foreign tax paid on the income producing assets. However, through structured finance, the U.S. entity is able to shift some of the tax burden to a foreign entity. Example 7 of Section 901-2(e)(5)(iv) illustrates a common asset holding transaction.\textsuperscript{25}

\textsuperscript{24} See id.

\textsuperscript{25} Proposed IRC § 901-2(e)(5)(iv) Example 7:

Facts. (A) A domestic corporation (USP) contributes $6 billion of country Z debt obligations to a country Z entity (DE) in exchange for all of the class A and class B stock of DE. A corporation unrelated to USP and organized in country Z (Fcorp) contributes $1.5 billion to DE in exchange for all of the class C stock of DE. DE uses the $1.5 billion contributed by Fcorp to redeem USP's class B stock. The class C stock is entitled to "all" income from DE. However, Fcorp is obligated immediately to contribute back to DE all distributions on the class C stock. USP and Fcorp enter into --

(1) A forward contract under which USP agrees to buy after five years the class C stock for $1.5 billion; and

(2) An agreement under which USP agrees to pay Fcorp interest at a below-market rate on $1.5 billion.

(B) For U.S. tax purposes, these steps create a secured loan of $1.5 billion from Fcorp to USP. Therefore, for U.S. tax purposes, USP is the owner of both the class A and class C stock. DE is a disregarded entity for U.S. tax purposes and a corporation for country Z tax purposes. In year 1, DE earns $400 million of interest income on the country Z debt obligations. DE makes a payment to country Z of $100 million with respect to such income and distributes the remaining $300 million to Fcorp. Fcorp contributes the $300 million back to DE. USP and Fcorp are not related within the meaning of paragraph (e)(5)(iv)(C)(6) of this section. Country Z does not impose tax on interest income derived by U.S. residents.

(C) Country Z treats Fcorp as the owner of the class C stock. Pursuant to country Z tax law, Fcorp is required to report the $400 million of income with respect to the $300 million distribution
The Treasury Department maintains that all parties to the transaction benefit as a result of the reduction in the U.S taxpayer’s liability.\textsuperscript{26} Accordingly, the United States entity’s burden is reduced by the participation of the foreign counterparty and the foreign counterparty, in turn, enjoys a foreign tax credit.\textsuperscript{27} The foreign jurisdiction also receives more tax revenue from the transaction than it would in a direct asset transfer.\textsuperscript{28}

**III. AMERICAN JURISPRUDENCE:**

*Biddle and its Progeny*

The IRS has, to some extent, relied on the American court system to legislate from the bench. In this respect, the judiciary has been responsible for evaluating equitable principles and the facts of many transactions in order to determine whether an abuse of the foreign tax credit regime has occurred. To this effect, the United States courts have approached the issue of abuse from a perspective of determining who the taxpayer is in a given transaction. Once the proper taxpayer has been determined, the court goes on to answer a number of other relevant questions, including whether a foreign tax payment is deemed compulsory or voluntary under United States law. These issues are categorized and summarized in the following section.

In determining the taxpayer, it is helpful to determine what taxes should be paid and who should be paying them. One of the first steps in answering these questions is to analyze the laws of each country associated with the transaction. However, in so doing,

\textsuperscript{26} See Proposed IRC § 901-2(e)(5) Preamble at 7.
\textsuperscript{27} See id.
\textsuperscript{28} See id.
one inevitably must assess which jurisdiction’s law is controlling under the circumstances. In 1938, the United States Supreme Court attempted to answer this question when it handed down its decision in Biddle v. Commissioner. 29 Biddle and its progeny of conflicted and confounding opinions are responsible for the foundation of American Jurisprudence on the topic of determining the taxpayer.

In Biddle, United States taxpayers received cash dividends as a result of their stock ownership interest in three British corporations. 30 One of the British corporations, prior to making its respective distribution, paid British tax on its income. 31 The amount paid by the corporations to the British government was controlled by British tax law. 32 Having been duly taxed on its income, the British corporation decided to issue dividends to its stockholders in accordance with its corporate charters. 33 The other two corporations purported to distribute their dividends ‘tax free.’ 34 Although the corporations treated their tax liabilities differently, they disclosed the appropriate amount of tax attributable to each dividend. 35 Pursuant to British law, “[i]n these circumstances the corporations are directed to certify to shareholders, at the time of sending out warrants for the dividends, the gross amount from which the income tax ‘appropriate thereto’ is deducted, the rate and amount of the income tax appropriate to the gross amount, and the net amount actually paid.” 36

29 302 US 573 (1938).
30 See id. at 575.
31 Id.
32 Id.
33 Id.
34 Id.
35 Id.
36 Id. at 576 fn 2 (Section 33, Finance Act of 1924, 14 and 15 Geo. V, c. 21).
The taxpayers claimed the gross dividend amount and the maximum tax credit attributable to the income received with respect to all three corporate distributions.\(^{37}\) The issue before the court was simplified as such “whether the taxpayers, after adding to gross income the amounts included in the British returns as taxes appropriate to the dividends received, were then entitled to deduct those amounts from the tax as computed, to the extent permitted by section 131(b), and whether the excess was a permissible deduction from gross income.”\(^{38}\)

Although these were the issues in front of the court, for the purpose of this article, the rule of law pronounced in this decision was that the controlling law concerning the granting of foreign tax credits was that of the jurisdiction where the taxpayer resides.\(^ {39}\) Here, under British law, the taxpayers were considered to have paid the attributable tax on their income received.\(^ {40}\) However, under the United States rules, the taxpayers were deficient in their income tax. Thus, the tax paid by the British corporation prior to making the distribution was not considered a creditable tax for the purpose of the individual taxpayer’s United States income statement.\(^ {41}\) The Court ultimately found that “[t]he power to tax and to grant the credit resides in Congress, and it is the will of Congress which controls the application of the provisions for credit.”\(^ {42}\)

Once the Supreme Court decided the issue of which jurisdiction’s laws would control the issuing of foreign tax credits, the issue shifted to determining which party to

---

\(^{37}\) *See Biddle*, 302 U.S. at 577.

\(^{38}\) *Id.* at 577.

\(^{39}\) *Id.* at 579. (“deductions of ‘income * * * taxes imposed by the authority of any foreign country’ are limited to taxes paid or accrued [by the taxpayer]”).

\(^{40}\) *Id.* at 577. (“The scheme of the British legislation is to impose on corporate earnings only one standard tax, at the source, and to avoid the ‘double’ taxation of the corporate income as it passes to the hands of its stockholders, except as they are subject to surtax which the corporation does not pay.”)

\(^{41}\) *Id.* at 581. (“Our revenue laws give no recognition to that conception.”)

\(^{42}\) *Id.* at 576.
the transaction was responsible for the tax liability created. Judge Posner of the Seventh Circuit tackled this issue in the case of Continental Illinois Corp. v. Commissioner in 1993.43

The issue before the Continental Court was whether “net loans” to a foreign party created a tax liability on the foreign party paying the tax in the foreign jurisdiction or rather on the United States lender.44 Justice Posner reasoned in his opinion that the structure of the transaction and the taxes paid thereunder, although paid by the borrower, are “really” imposed on the lender and therefore are not creditable under the foreign tax credit system.45 As Sheppard notes in his analysis, “[f]oreign tax credit case law does not look kindly on voluntary agreements to pay someone else's tax.”46

43 998 F.2d 513 (5th Cir. 1993).
44 See id. at 515-516 (Judge Posner provides a comprehensive definition and explanation of the net loans in question: “‘Net loans’ are loans net of any tax that the borrower's country imposes on the interest. In a gross loan, the parties agree to an interest rate, and the interest is paid to the lender subject to any obligation that local law imposes on the borrower to withhold the tax that the lender owes on the interest. Thus, if the agreed rate of interest is 12 percent and the withholding rate 25 percent, the borrower remits only 9 percent interest to the lender and pays the rest to the local *516 taxing authority. In a net loan, the parties agree upon the interest that the lender will be entitled to receive net of any local tax on it; this protects the borrower against an unexpected increase in the tax rate. Determination of the tax due on the interest for such a loan generally requires computing a grossed-up interest income figure (which we'll call x) that will generate the same amount of tax that would have been due had the form of the loan not been changed from gross to net. To compute x requires first computing what we will call r, the rate that, after subtraction of (in our example) 25 percent of the rate, equals the agreed-upon after-tax interest rate. So: r - .25r = 9%; r = 12%. The grossed-up income (x) is simply r times the amount of the loan. What we are calling x and r will nowhere be specified in the loan contract. They are artifacts created in order to make sure that net lending will not be used to reduce the lender's tax liability to the foreign country. In both the gross and the net loan the lender receives (in our example) 9 percent on his money after tax. The difference is that in the gross loan a change in the tax rate will raise or lower the amount of money the lender can take out of the country because his entitlement is to interest before the tax on it is computed or paid, and a change in the tax rate will therefore change what he can take out, while in a net loan a change in the tax rate will not affect the amount of money that he can take out of the country because the contract for such a loan entitles him to a fixed amount of interest over and above the local tax, whatever that tax may be.”).
45 See id. at 518 (“Naturally the Brazilian and American tax systems are not identical, but the differences between them with respect to withholding are too minor to justify a conclusion that Brazil is “really” taxing the borrower and not the lender. The essential similarity is that the tax is based on the income received by the lender. Such a tax is an income tax. Actually it is a gross-receipts tax rather than an income tax, because the cost of lending is not netted out of the interest received by the lender.”).
46 Sheppard, supra note 5, at 8.
Biddle reared its head some fifty years later when the Claims Court decided Xerox v. United States.\textsuperscript{47} In Xerox, RXL, a subsidiary of Xerox acting as European operating agent, paid massive dividends to both the parent company and another subsidiary of the parent company.\textsuperscript{48} RXL, a British company, was subject to British regulations and laws concerning its tax liabilities, including the British Finance Act of 1972 under which the corporation was subject to advance corporation tax (ACT) including any dividends distributed.\textsuperscript{49} The question presented to the court was whether such distributions net ACT were entitled to a foreign tax credit on the receiver side.\textsuperscript{50} The Claims Court looked to article 23 of the U.S.-U.K. Income Tax Treaty of 1975 to find that the parent company must reduce its foreign tax credits by any amount claimed under the ACT.\textsuperscript{51}

Sheppard identifies a problem with the logic imposed in Xerox: “Xerox would sustain a foreign tax credit claimed under a contractual agreement by one taxpayer to pass its tax liability to another taxpayer so long as the latter has an independent foreign tax liability.”\textsuperscript{52} This is seemingly inconsistent with the view expressed in Biddle.

Now that the controlling jurisdiction, the controlling law and the appropriate taxpayer have been identified, per the Biddle progeny, let us turn our attention to the nature of the transaction itself. The IRS has experienced a turbulent past in this regard. Take, for example, the infamous and much maligned Example 5 of Notice 98-5.\textsuperscript{53} In the Notice, the Treasury Department and the IRS classified the following transaction as abusive under the current rules and regulations concerning cross-border transactions involving foreign tax credits arbitrage:

\textsuperscript{47} 14 Ct. Cl. 455 (1988).
\textsuperscript{48} See id. at 456.
\textsuperscript{49} Id.
\textsuperscript{50} Id.
\textsuperscript{51} Id.
\textsuperscript{52} Sheppard, supra note 5, at 7-8.
\textsuperscript{53} See Notice 98-5, Example 5.
Example 5

US, a domestic corporation, forms N, a Country X entity. US contributes $100.00 to the capital of N in exchange for a 100-percent ownership interest. N borrows $900.00 from F, an unrelated Country X corporation, at an annual interest rate of 8 percent, and N purchases preferred stock of an unrelated party with a par value of $1000.00 that US reasonably expects to pay dividends at an annual rate of 10 percent.

The dividends are subject to a Country Y 25-percent withholding tax. Country X treats the F loan as an equity investment in N and treats N as a partnership. Consequently, F claims a foreign tax credit in Country X for 90 percent of the withholding tax paid by N. Under U.S. law, the F loan is respected as debt, and N [*12] is disregarded as a separate entity (a partnership with only one partner). see Reg. § 301.7701-3 (a) and § 301.7701-3 (b) (2) (C). Thus, US claims a U.S. foreign tax credit for the taxes paid by N and the tax benefit of the foreign taxes paid by N are effectively duplicated.

At the time US enters into this arrangement, US reasonably expects an annual profit of $3.00 ($100.00 dividend income, less $72.00 interest expense and $25.00 foreign tax liability) and an annual foreign tax credit of $25. In this example, US has entered into an arrangement to exploit the inconsistency between U.S. and Country X tax laws in order to generate foreign tax credits in a transaction with respect to which the reasonably expected economic profit is insubstantial in relation to expected U.S. foreign tax credits.\(^5\)

The argument the Treasury Department and the IRS proposed against such transactions was that they were inherently abusive because they lacked both economic substance and a business purpose other than to generate foreign tax credits.\(^5\) The test employed by the IRS was thus dubbed the “economic substance” test.\(^5\) Among other things, this test was critical of any transaction in which the economic profit generated by the transaction was proportionally small compared to the foreign tax credit generated by the same transaction.\(^5\)

Despite the attempts of the IRS to cut back on abusive arrangements to exploit the foreign tax credit system, the economic substance test raised more problems than it

---

\(^5\) Notice 98-5, Example 5.
\(^5\) Id.
\(^5\) Id.
\(^5\) Id. (“In abusive arrangements involving such transactions, the U.S. taxpayer exploits these inconsistencies where the expected economic profit is insubstantial compared to the foreign tax credits generated.”); see also Sheppard part 1 page 6 (“Example 5 of Notice 98-5 was premised on the U.S. corporation’s income from the foreign SPE being disproportionately small compared with the foreign tax credit.”).
solved. Perhaps the beginning of the end for the test came in Compaq Computer Corp. v. Commissioner.\textsuperscript{58} In the transaction in question Compaq purchased and resold a set of foreign securities utilizing American Depository Receipts, or ADRs.\textsuperscript{59} In response to Compaq’s income tax return for the year in question, the IRS sent Compaq a notice of deficiency for foreign tax credits claimed in connection with the transaction.\textsuperscript{60} The IRS attacked the foreign tax credit claim solely on the basis that the transaction lacked economic substance.\textsuperscript{61} The Fifth Circuit vehemently rejected the economic substance argument posed by the IRS under the rule of law set forth under Old Colony Trust Co. v. Comm’r.\textsuperscript{62} The court reasoned that to strike down the credits claimed in this transaction would be in direct conflict with the purpose of foreign tax credits: to prevent double taxation.\textsuperscript{63}

As a result of the IRS’s failure to successfully assert the economic substance argument in Compaq and other case, the Commissioner released Notice 2004-19, in which it stated its intent to no longer attack foreign tax credit claims on the grounds of an economic substance argument.\textsuperscript{64} Nevertheless, the IRS refused to back down from its stance that foreign tax credit arbitrage resulted in an abuse of the foreign tax credit scheme and announced that it would continue to pursue these transactions in an administrative fashion:

\footnotesize
\textsuperscript{58} 277 F.3d 778 (5th Cir. 2001).
\textsuperscript{59} See Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001) (explaining ADRs: “An ADR is a trading unit, issued by a trust, that represents ownership of stock in a foreign corporation. Foreign stocks are customarily traded on U.S. stock exchanges using ADRs. An ADR transaction of the kind at issue in this case begins with the purchase of ADRs with the settlement date at a time when the purchaser is entitled to a declared dividend -- that is, before or on the record date of the dividend. The transaction ends with the immediate resale of the same ADR with the settlement date at a time when the purchaser is no longer entitled to the declared dividend -- that is, after the record date. In the terminology of the market, the ADR is purchased ‘cum dividend’ and resold ‘ex dividend.’”).
\textsuperscript{60} See id. at 780.
\textsuperscript{61} Id.
\textsuperscript{62} 279 U.S. 716 (1929).
\textsuperscript{63} Compaq, 277 F.3d at 785 (“The purpose of the Revenue Code's foreign tax credit provisions is to reduce international double taxation.”).
\textsuperscript{64} See Notice 2004-19 (withdrawing Notice 98-5 and the economic substance test).
The IRS will continue to scrutinize abusive transactions that are designed to generate foreign tax credits. In appropriate circumstances, the IRS will challenge the claimed tax consequences of such transactions under the following principles of existing law: the substance over form doctrine, the step transaction doctrine, debt-equity principles, section 269, the partnership anti-abuse rules of § 1.701-2, and the substantial economic effect rules of §1.704-1.\textsuperscript{65}

Of course, as Sheppard points out, the issue of whether to go after pure arbitrage is still very much in debate amongst top brass at the IRS.\textsuperscript{66}

\textbf{IV. Proposed Regulation 901-2(e)(5)(iv)(B): Six Conditions Indicating Impropriety}

One of the chief aims of proposed regulation 901-2(e) is to cut back on structured finance transactions that take abuse the foreign tax credit scheme. Although the economic substance argument has effectively been struck down by opponents to the rule, the IRS continues to rigorously challenge foreign tax credit claims in transactions that have little business purpose. One such tool the IRS enlists is the compulsory payment argument.

In order for a foreign tax credit claim to be made, the proponent of the claim must assert that it has made a compulsory tax payment to a foreign jurisdiction in accordance with regulation sections 1.901-2(a)(2)(i) and (e)(5). In particular, regulation section 1.901-2(e)(5)(i) states in pertinent part:

\begin{quote}
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 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.
\end{quote}

\textsuperscript{65}Id. (declaring its intent to continue to pursue abusive transactions).

\textsuperscript{66}See Sheppard, supra note 5, at 9 (pointing out the deference Dale Collison, IRS special counsel to the associate chief counsel, was willing to afford tax strategists when it comes to foreign tax credit arbitrage, while IRS commissioner Mark Everson expressed an interest in going after such transactions.)
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).\textsuperscript{67}

This section is left untouched by the proposed regulations and therefore remains intact as an appropriate tool for IRS challenges. Furthermore, regulation section 1.0-1-2(a)(2)(i) proclaims that the United States law shall control when a question of whether a payment is compulsory or not is presented.\textsuperscript{68} Accordingly, as Sheppard notes, the question has been the subject of much litigation.\textsuperscript{69} It is also worth noting that the regulation poses a significant duty upon the party claiming the foreign tax credit to seek competent authority on whether its actions constitute proper conduct.\textsuperscript{70}

The IRS, in response to increasing concerns that financial intermediaries were abusing the tax system through structured finance transactions in order to claim foreign tax credits, issued proposed amendments to regulation 1.901-2(e)(iv). The amendments, as a result of the failure of the economic substance test, lean heavily on compulsory payment definitions in order to limit banks’ abilities to artificially generate foreign tax credits.

As Sheppard properly indicated, the proposed amendments to the regulation controlling foreign tax credits pose a striking resemblance to the points raised by Yaron Reich earlier this

\textsuperscript{67} IRC §1.901-2(e)(i).
\textsuperscript{68} See IRC §1.0-1-2(a)(2)(i) (Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country. Therefore, the assertion by a foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto.).
\textsuperscript{70} See IRC § 1.901-2(e) (“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.”).
year. In his paper, Reich identifies five factors that ought to be considered in determining whether the structured passive investment should be declared abusive:

(1) a joint investment by the U.S. party and the foreign party;
(2) inconsistent characterization of their interests in the investment vehicle by their home countries;
(3) U.S. party claim for a foreign tax credit for tax paid by the investment vehicle;
(4) and claim for tax benefits associated with ownership by the foreign party; and
(5) compensation paid to the U.S. party by the foreign party for the latter’s tax benefit.

These factors, as set forth by Reich, seem to form the basis for the factors set forth in the proposed amendments to regulation section 1.901-2.

The six criteria highlighted by the proposed amendment are summarized by Sheppard as follows:

(1) a special-purpose vehicle (SPV) earning substantially all passive income on which a purported foreign tax payment is made;
(2) a U.S. party eligible to claim a section 901, 902, or 960 credit for that payment;
(3) which payment is substantially greater than it would have been had the U.S. party directly owned the SPV's assets;
(4) some foreign benefit to an unrelated counterparty;
(5) which owns at least 10 percent of the SPV or acquires at least 20 percent of its assets under foreign law; and
(6) inconsistent treatment of the arrangement in the United States and the pertinent foreign country.

These criteria apply equally to all three categories of structured finance highlighted by the proposed amendments, U.S. borrower, U.S. lender, and asset holding transactions.

That is probably what makes them so attractive to the regulators that support the amendment’s passage. Each of the factors is narrowly tailored to fit the purpose of the

71 See Sheppard, supra note 51, at 7.
73 Sheppard, supra note 51, at 7; cf. Proposed IRC § 1.901(e)(iv)(B)(1)-(6) (note that the actual proposed regulation sets forth these criteria in a much more detailed fashion and I have chosen to submit Sheppard’s summary in the interest of space and coherence.).
amendments, effectively rebutting any challenge to the breadth of the power asserted by the IRS in this case. The presence of all six of these factors will result in a determination by the IRS of a non-compulsory payment made to a foreign jurisdiction and an abuse of the foreign tax credit system. In addition, the preamble to section 1.901-2 notes that the IRS may look into any other factor it deems reasonable for the purpose of analyzing certain passive investments under this section of the Internal Revenue Code.\textsuperscript{74}

The enabling factor highlighted by the proposed regulation is undoubtedly the sixth, inconsistent treatment. The regulation gives the following four conditions under which inconsistent treatment between jurisdictions may be found:

(i) The classification of the SPV (or an entity that has a direct or indirect ownership interest in the SPV) as a corporation or other entity subject to an entity-level tax, a partnership or other flow-through entity or an entity that is disregarded for tax purposes.
(ii) The characterization as debt, equity or an instrument that is disregarded for tax purposes of an instrument issued by the SPV (or an entity that has a direct or indirect ownership interest in the SPV) to the U.S. party, the counterparty or a person related to the U.S. party or the counterparty.
(iii) The proportion of the equity of the SPV (or an entity that directly or indirectly owns the SPV) that is considered to be owned directly or indirectly by the U.S. party and the counterparty.
(iv) The amount of taxable income of the SPV for one or more tax years during which the arrangement is in effect.\textsuperscript{75}

The inconsistent treatment of the United States and the foreign jurisdiction of any of the four factors listed \textit{supra} will result in a determination of inconsistent treatment for the purpose of the proposed regulation. The inconsistencies are further illuminated by Sheppard, “[i]f a hybrid entity is used, then the inconsistent treatment is that one country treats it as transparent and the other as opaque. If a hybrid security is used, then the inconsistent treatment is that one country treats it as debt and the other as equity. If a repo is used, then each country treats its resident as

\textsuperscript{74} See IRC § 1.901-2.
\textsuperscript{75} Proposed IRC § 1.901-2(e)(iv)(6).
owner of the repoed securities, either by virtue of legal title or the right to get the securities back.”

Returning to the three examples of transactions set forth in Section I of this paper, let us now apply the six factors set forth above and see what results.

The first transaction involved a U.S. borrower and a foreign lender where the borrower seeks cheaper funds abroad through the conversion of deductible interest expense into claimable foreign tax credits. The result of the transaction prior to the adoption of the proposed regulation would yield a $36 million foreign tax credit and an $84 million deductible interest expense to USP. However, with the new regulation in place, the transaction would satisfy all six of the conditions set forth in 1.901-2(e)(iv)(B). Example 1 under proposed regulation 1.901-2(e)(iv) provides a more detailed explanation of the result under this section. Under the new regulations, the tax paid to the foreign jurisdiction in Example 1 would not qualify as a compulsory payment and USP would not be entitled to a foreign tax credit as a result.

The second transaction contemplated under Section I of this paper is a U.S. lender transaction with a foreign borrower. Sheppard notes the difficulty the Government

---

76 Sheppard, supra note 51, at 7.

77 Proposed IRC §1.901-2(e)(iv) Example 1:

Result. The payment by Newco to country M is not a compulsory payment, and thus is not an amount of tax paid. First, Newco is an SPV because all of Newco's income is passive investment income described in paragraph (e)(5)(iv)(C)(4) of this section, Newco's only asset, a note, is held to produce such income, and the payment to country M is attributable to such income. Second, if the foreign payment were treated as an amount of tax paid, USP would be deemed to pay the foreign payment under section 902(a) and, therefore, would be eligible to claim a credit for such payment under section 901(a). Third, USP would not pay any country M tax if it directly owned Newco's loan receivable. Fourth, distributions from Newco to FP are exempt from tax under country M law. Fifth, FP is a counterparty because FP and USP are unrelated and FP owns more than 10 percent of the stock of Newco under country M law. Sixth, FP is the owner of 100 percent of Newco's stock for country M tax purposes, while USP is the owner of 100 percent of Newco's stock for U.S. tax purposes, and USP's ownership of the stock would materially affect the amount of credits claimed by USP if the payment to country M were an amount of tax paid. If the foreign payment were treated as an amount of tax paid, USP's ownership of the stock for U.S. tax purposes would make USP eligible to claim a credit for such amount under sections 901(a) and 902(a). Because the payment to country M is not an amount of tax paid, USP has dividend income of $84 million and is not deemed to pay any country M tax under section 902(a). USP also has interest expense of $84 million. FSub's post-1986 undistributed earnings are reduced by $120 million of interest expense.
subscribes to regulating this type of transaction because of long standing tax treaties reluctance to recognize foreign interest income.\textsuperscript{78} The result of this type of structured passive investment prior to the effective date of proposed regulation would yield a $48 million foreign tax credit for Newco. Example 4 of proposed regulation section 1.901-2(e)(iv) explains the results of the U.S. lender transaction in greater detail.\textsuperscript{79}

\textsuperscript{78} See Sheppard, \textit{supra} note 51, at 10.
\textsuperscript{79} Proposed IRC § 1.901-2(e)(iv) Example 4:

\textit{Result.} (A) The payment to country X is not a compulsory payment, and thus is not an amount of tax paid. First, Newco is an SPV because all of Newco's income is passive investment income described in paragraph (e)(5)(iv)(C)(4) of this section, Newco's sole asset, stock of RH, is held to produce such income, and the payment to country X is attributable to such income. Second, if the foreign payment were treated as an amount of tax paid, USB would be deemed to pay the $48 million under section 902(a) and, therefore, would be eligible to claim a credit under section 901(a). Third, USB would not pay any country X tax if it directly owned its proportionate share of Newco's asset, the 99 percent interest in RH, because under the U.S.-country X tax treaty country X would not impose tax on USB's distributive share of RH's interest income. Fourth, foreign bank is entitled to interest deductions under country X law for interest it pays and accrues to RH, and will receive tax-free dividends from Newco upon payment of the accrued interest. Fifth, foreign bank and USB are unrelated and foreign bank is considered to own more than 10 percent of Newco under country X law. Sixth, the U.S. and country X view several aspects of the transaction differently, and the U.S. treatment would materially affect the amount of credits claimed by USB if the country X payment were an amount of tax paid. If the country X payment were treated as an amount of tax paid, the equity treatment of the securities for U.S. tax purposes would make USB eligible to claim a credit for the payment under sections 901(a) and 902(a). Moreover, the fact that Newco recognizes a smaller amount of income for U.S. tax purposes than it does for country X tax purposes would increase the amount of credits USB would be eligible to claim upon receipt of the $ 44 million distribution. Because the $48 million payment to country X is not an amount of tax paid, USB has dividend income of $44 million. It is not deemed to pay tax under section 902(a).

(B) In addition, RH is an SPV because all of RH's income is passive investment income described in paragraph (e)(5)(iv)(C)(4) of this section, RH's sole assets, notes of foreign bank, are held to produce such income, and Newco's payment to country X is attributable to such income. Second, if the foreign payment were treated as an amount of tax paid, USB would be deemed to pay the $48 million under section 902(a) and, therefore, would be eligible to claim a credit under section 901(a). Third, USB would not pay any country X tax if it directly owned its proportionate share of RH's assets, notes of foreign bank, because under the U.S.-country X tax treaty country X would not impose tax on interest paid by foreign bank to USB. Fourth, foreign bank is entitled to interest deductions under country X law for interest it pays and accrues to RH, and will receive tax-free dividends from Newco upon payment of the accrued interest. Fifth, foreign bank and USB are unrelated and foreign bank is considered to own directly or indirectly more than 10 percent of RH under country X law. Sixth, the U.S. and country X view several aspects of the transaction differently, and the U.S. treatment would materially affect the amount of credits claimed by USB if the country X payment were an amount of tax paid. If the country X payment were treated as an amount of tax paid, the equity treatment of the Newco securities for U.S. tax purposes would make USB eligible to claim a credit for the payment under sections 901(a) and 902(a). Moreover, the entity classification of RH for U.S. tax purposes results in Newco recognizing a smaller amount of income for U.S. tax purposes than it does for country X tax purposes, which would increase the amount of credits USB would be eligible to claim upon receipt of the $44 million distribution.
Given the fact that the transaction meets all six criteria as set forth in section 1.901-2(e)(iv)(B), the payment to country X will no longer qualify as a compulsory payment and Newco will no longer be eligible for a foreign tax credit under this section.

The third and final transaction contemplated in Section I of this paper is the asset holding transaction. The result before the codification of the proposed regulation would lead to the U.S. corporation claiming a $100 million foreign tax credit. Example 7 of the proposed regulation explains the result in grave detail.\(^{80}\)

Under the amendments to the compulsory payment standard, all six conditions of section 1.901-2 are met in this asset holding transaction and the taxes paid to the foreign government are not creditable. As Sheppard observes, the transaction is merely an economic sharing of tax expense for which both parties are able to claim tax credits.\(^{81}\)

This kind of double-dipping is presumptively an abuse of the foreign tax credit system and is the kind of behavior sought to be dissuaded by the proposed amendments.

---

Because the $48 million payment to country X is not an amount of tax paid, USB has dividend income of $44 million. It is not deemed to pay tax under section 902(a).

\(^{80}\)Proposed IRC § 1.901-2(e)(iv) Example 7:

Result. The payment to country Z is not a compulsory payment, and thus is not an amount of tax paid. First, DE is an SPV because all of DE's income is passive investment income described in paragraph (e)(5)(iv)(C)(4) of this section, all of DE's assets are held to produce such income, and the payment to country Z is attributable to such income. Second, if the payment were treated as an amount of tax paid, USP would be eligible to claim a credit for such amount under section 901(a). Third, USP would not pay any country Z tax if it directly owned DE's assets. Fourth, Fcorp is entitled to claim a credit under country Z tax law for the payment and will recognize a loss under country Z law upon the "sale" of the class C stock. Fifth, Fcorp and USP are not related within the meaning of paragraph (e)(5)(iv)(C)(6) of this section and Fcorp is considered to own more than 10 percent of DE under country Z law. Sixth, the United States and country X view certain aspects of the transaction differently and the U.S. treatment would materially affect the amount of credits claimed by USP if the country Z payment were an amount of tax paid. USP's ownership of the class C stock for U.S. tax purposes would make USP eligible to claim a credit for the country Z payment if the payment were treated as an amount of tax paid.

\(^{81}\)See Sheppard, supra note 51, at 8.
It should be noted that all three of these deals are not invalidated because of the ramifications of the proposed regulations; however, the economic consequences of these regulations would certainly serve as a deterrent to enter into any such transactions.

V. Proposed Regulation 901-2(e)(5)(iv)(B): Narrow Solution to a Broad Problem

Many critics of the proposed regulation have argued that the rule, while long overdue, is an unfit solution to a problem of massive proportions. As noted supra, the foreign tax credit arbitrage dilemma is causing deficiencies upwards of $3.5 billion, a number at which no economist or tax strategist would scoff. In an effort to address this issue, the IRS and the Treasury Department have proposed a narrowly tailored solution by the way of rule-based guidance. Whether regulation is the proper solution to the problem is not a matter discussed in the present paper, but is an issue well worth consideration. Nevertheless, this paper does take a position consistent with tax analysts Lee Sheppard, Kevin Dolan and Bret Wells that the proposed regulations’ narrow tailored answer is ultimately an inadequate solution to the problem of international arbitrage transactions generating improper foreign tax credits.

Dolan argues for the complete abandonment of the proposed regulations under the pretense that the economic substance doctrine would invalidate all of the potential transactions targeted by the proposed regulations. Although this argument is somewhat problematic in its outward promotion of the now withdrawn Notice 98-5 Example 5 and its economic substance doctrine, Dolan does make many valid policy arguments against the proposed rule-based guidance. He points out, rather eruditely, that “there is no tax

---

policy and certainly no authority that would suggest that a transaction that results in excess foreign tax credits is problematic per se, and the proposed regulation does not make excess credits noncreditable per se.” 83  The assertion Dolan makes raises an interesting policy question: why is the government so concerned with limiting a practice it should have no interest in overseeing? The answer is probably a mixture of public policy and shameful economic practice.

The second argument Dolan poses is against the manner in which the IRS has chosen to limit these transactions. Dolan believes that rule-based guidance, generally speaking, is ineffective. “A rules-based rule can be a rifle shot that hits only one piece of the logical target or hits the wrong target. Alternatively, it can be a scattershot, hitting many wrong targets and causing collateral damage. Rules-based rules are an inefficient and ineffective way to administer a tax system.” 84  What this argument has in merit it lacks in substance. Unfortunately, Dolan fails to flesh out his argument against rule-based guidance adequately. As a result, the reader is left to wonder what potential wrongs may be had in a world of regulatory guidance. Is the informed tax strategist really left in an ambiguous world of examples and explanations of IRS defined abusive behavior?

Dolan nevertheless correctly points out the fundamental problem pursued in the proposed regulation when he states, “because there is no voluntary payment issue, the proposed regulation cannot be supported by voluntary payment concepts. The proposed regulation is simply an antiarbitrage rule for which there must be some basis in law other

83 Id.
84 Id.
than voluntary payment principles for the rule to be valid.”85 In so stating, Dolan attacks the proposed regulation for rule making under false pretenses. The argument is interesting in that it suggests that the IRS, financially and intellectually handicapped compared to its private sector counterparts, is struggling to solve a phantasmal fiscal issue. “If the government believes there is a problem that economic substance principles cannot cure, it should figure out what that problem is and develop a principled legislative proposal to address it.”86 Unfortunately, Dolan’s economic substance proposal falls short of any real significance as a result of Notice 2004-19 and the IRS’s blatant withdrawal of the economic substance doctrine.87

Wells, on the other hand, attacks the proposed regulations on three fronts. The first argument Wells offers is that the proposed regulations inappropriately override US tax treaties. This contention is premised on a definition of the word ‘tax’: “when the US government uses the term ‘tax,’ implicit in that understanding is that the payment is a ‘compulsory payment’ because this is what the term ‘tax’ means in the US sense.”88 Wells uses this definition to narrowly define the term, but he also uses it to show how the discourse of taxation has depended on such definitions in order to provide bright-line, unambiguous rules. This is evident in Wells’ next logical step in which he criticizes the proposed regulations for condemning a type of transaction heretofore unmentioned in US tax policy. “In this regard, just as was the case back in 1982, each of the current US bilateral tax treaties use terms of art such as the term ‘tax,’ and the US government has

\[\text{Id.}\]
\[\text{Id.}\]
\[\text{Id.}\]

Nevertheless, the argument gathers some strength in the Preamble to proposed IRC § 1.901-2(e), where the IRS seemingly breathes life into the once dead economic substance doctrine. How courts will treat an attack on structured finance under the pretenses of the proposed regulations in conjunction with the economic substance doctrine remains to be seen and debated.

used this exact term of art to acknowledge that the treaty partner's levy represents a ‘tax’ in the US sense of that term. In addition, existing US bilateral tax treaties do not contain a carve-out for highly structured passive transactions and in fact that concept has never before existed under US domestic tax law prior to this regulatory pronouncement.”

In so doing, Wells contends that “[s]ince it appears that the proposed Section 901 regulations are targeting transactions that involve treaty partners in an effort to treat foreign taxes as a ‘non-tax’ levy, the current Section 901 regulations represent a regulatory effort to override US bilateral tax treaties that have been ratified by the US Senate without any prior legislative authorization for such action.”

The second argument Wells proposes against ratifying the proposed regulations is that they are wholly inconsistent with domestic tax law. The foundation of this argument is that “Congress has had a longstanding intent with respect to the US foreign tax credit regime to protect against erosion of the US taxing jurisdiction of US domestic source income even at the expense of creating international double taxation.” In support of this contention, Wells offers this summary of the legislative history with regard to the foreign tax credit regime: “the US foreign tax credit regime is intended to prevent international double taxation except to the extent necessary to protect the US taxing jurisdiction on US domestic source income and to the extent necessary to protect against prohibited cross-crediting of taxes against low-taxed foreign source income.” Accordingly, the proposed regulations, in Wells' mind, constitute an impermissible end-run around, where the IRS has improperly usurped Congress’ legislative authority by

---

89 Id.
90 Id.
91 Id.
92 Id.
attempting to address the legitimacy of a foreign jurisdictions taxing authority, a right reserved by Congress in section 904.

The third, and final argument advanced by Wells is that of the economic substance and business purpose doctrine. Much like Dolan, Wells argues for the revival of the economic substance doctrine to attack structured finance deals that generate foreign tax credits in an abusive fashion. Unfortunately for both of them, the economic substance doctrine no longer exists in its authoritative fashion and is merely ideological reminiscing. However, Wells does submit that in order for these transactions to successfully claim a foreign tax credit, they must serve a legitimate business purpose.93 Much to Wells’ dismay, the proposed regulations give no guidance as to what would or should be considered such a purpose. To his own fault, Wells does not offer any guidance himself. “If adopted, the proposed Section 901 regulations would provide negative assurance that transactions that fall outside the six-factor test set forth in the proposed Section 901 regulations are ‘acceptable’ even if those transactions have questionable business purpose support.”94 He goes on to say, “[a] better approach would be to clearly state that non-economic transactions that do not satisfy business purpose requirements are not going to be respected for tax purposes. The proposed regulations miss this opportunity. By articulating a checklist instead of a clear standard, these proposed regulations are incapable of providing insight about how to assess which factors are creating an issue and what happens if the same tax results are achieved but with slightly different factors.”95 Thus, Wells would much rather the IRS and the Treasury

---

93 See id.
94 Wells, supra note 68.
95 Id.
Department issue a more specific exclusionary rule rather than the rule-based guidance it offers by the way of its proposed amendments to regulation section 901.

Sheppard agrees with the both Dolan and Wells theories that “the narrow and detailed approach would be counterproductive in the long run.” She also agrees with Wells’ argument for lack of legislative authority. In addition, Sheppard maintains that the proposed regulations are inconsistent with current trends in foreign tax credit guidance issued by the same regulatory authorities.

This paper shares the view that the IRS and the Treasury Department’s actions in promulgating the proposed rules is inconsistent on a number of levels. In the preamble to the proposed regulation, the IRS claims that it will “continue to utilize all available tools under current law to challenge the U.S. 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 section 1.901-2(e), section 269, and the partnership anti-abuse rules of section 1.701-2.” This, in and of itself is perturbing in that the IRS would outwardly rely on a doctrine it had itself retracted as ineffective some three years earlier in a well documented albeit not well received Notice. Furthermore, the IRS and Treasury Department strike down the notion of a broad anti-abuse regulation in that it would create uncertainty. It is the contention of this paper that the claim in the next paragraph of the preamble causes more ambiguity than any broad anti-abuse statute could muster.

---

97 See id.
98 See id. (In support of her theory that the regulations contradict current foreign tax credit theory, Sheppard catalogues a list of Internal Legal Memorandum issued by the IRS contrasting the theoretical foundation espoused in the proposed regulations); cf. ILM 200620022.
99 Proposed IRC § 1.901-2(e) (emphasis added).
100 See Proposed IRC §1.901-2(e)(iv) Preamble.
VI. Conclusion

The IRS and Treasury Department pronounce the diligence with which they wish to go after the alleged abusive transactions in the preamble to the proposed regulations.\textsuperscript{101} However, in so doing, they offer the following guidance: “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.”\textsuperscript{102} It seems counter-intuitive to propose a bright-line rule-based guide to avoiding abusive behavior with the caveat that one, some, or all of the posted rules may or may not prove relevant. If the IRS wishes to carve out exceptions to the foreign tax credit regime, it should make these exceptions as narrow and well tailored as possible. The purpose of the proposed regulations is, in fact, to avoid ambiguity and offer relevant and well intentioned guidance to tax strategists looking for appropriate authority in structured finance. However, to do so with scepter of ambiguity is not helpful. In particular, to announce a narrowly tailored rule with a broad regulatory exception is an ideologically inconsistent practice that should be discouraged amongst regulatory authorities.

Furthermore, a broad anti-abuse strategy would better fit the intended purpose of the rule against anti-abuse in that it would undoubtedly have a chilling effect amongst tax strategists. While this proposition is somewhat near-sighted, in the world of ever evolving world perhaps a “quick-fix” with adaptable parts is exactly what the IRS and the Treasury Department should employ in order to battle the “abusive” tactics of certain structured passive investments. In addition, a broad anti-abuse rule, while consistent with the IRS’s main purpose of curbing abusive transactions, offers little by the way of guidance to tax strategists as to what may or may not be considered abusive practices. This is certainly a strong argument against granting the IRS

\textsuperscript{101} Id.
\textsuperscript{102} Id.
such broad discretion. Nevertheless, if the proposed regulation could simultaneously grant broad
discretion to the IRS while providing insightful direction to tax strategists, such a rule would
certainly be accepted amongst the tax community. Whether such a rule could even exist has yet
to be determined by even the most accomplished tax minds of both the private and public
sectors.