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Current & Quotable

Attorney Recommends Changes to U.S. Foreign Tax Credit Generator Regs

by Raymond J. Wiacek

Raymond J. Wiacek, a partner at Jones Day in Washington, presented the following comments at a July 30 IRS hearing on the proposed U.S. foreign tax credit generator regulations.

Where to start? Perhaps with the good intentions of the proposed 901-2(e)(5)(iv) regulations, because no one likes tax abuse. And there are transactions out there — involving asset parking, circular cash flows, related parties, the separation of tax from income, and so on — in which nothing much happens save the creation of a tax benefit based on the foreign tax credit. But the path to perdition is paved with good intentions, so it is fortunate the regulations are only proposed. They paint with a broad brush and need some work, in particular with respect to "U.S. borrower transactions."

So, let's start at the beginning. The very first sentence of the relevant preamble states that the transactions considered abusive are structured "in order to generate foreign tax credits." The next sentence repeats this, saying such transactions are structured "to create a foreign tax liability . . . ". These statements are silly. No one pays a tax to get credit for it. No one says, "Let's go out of pocket 33 cents on the dollar in order to get a credit of 33 cents, so that after lots and lots of work we can be flat." The more accurate statement is that taxpayers operating globally are *indifferent* to where they pay taxes. They do business all over the world, expect to pay taxes in various host jurisdictions, and expect not to be taxed a second time on the same income. It may be "unpatriotic" to be indifferent to where one pays taxes — as at least one tax journalist has charged — but, absent more, it is not abusive. And depending on one's view of globalization, free trade, and international competitiveness, it is not even unpatriotic. Stated otherwise, this is the indifference of tax neutrality, not abuse.

An exception to indifference and tax neutrality arises if a taxpayer has excess foreign source income. Then a taxpayer might be tempted to engage in foreign tax credit generation. Notice 98-5 recognized the generation of excess credits to shelter low tax income as the evil. And throughout the autumn of IRS and Treasury warnings of the new rules to come, the generation of excess foreign tax credits was one of the abuses highlighted. But the proposed regulations reject excess (or "disproportionate") credits as a discriminating test, ostensibly because some taxpayer "uncertainty" might result. This statement is not persuasive. Very few taxpayers will ever read these regulations. Those that do will discover they do not apply to them in the first few pages. Those that read further, and who understand and accept the abuses at which it is aimed, will also be pleased if they find exceptions at the end — for example, a business purpose exception or a disproportionate credit test — that prevent the proverbial throwing out of the baby with the bath. A regulation so structured would produce little if any uncertainty.

Another reason offered for rejecting an excess credit test is supposed uncertainty as to the allocation and apportionment of interest and other expenses in this context. This is a strange rationale to offer in the face of the section 861 regulations — comprehensive, highly articulated, and longstanding. Perhaps the section 861 regulations themselves need fixing, as noted below.

> ***The final regulations really should accommodate business purpose, even at the cost of some additional complexity — and even at the potential escape of some 'bad guys.'***

The third reason for rejecting an excess credit test is that some manipulation and abuse might survive such a test. The desire to end all abuse in this area, made paramount over any other obligation or objective, is a consistent theme of these regulations. The preamble, for example, acknowledges that administrability was favored over business purpose. It is appropriate to choose administrability over complexity, but it is not appropriate to choose simplicity over equity. The final regulations really should accommodate business purpose, even at the cost of some additional complexity — and even at the potential escape of some "bad guys." Collateral damage is no more appropriate in the war on tax shelters than it is in any other war.

A corollary of the foregoing is that the rhetoric in the preamble is overheated. Transactions that clearly occur are described as "purportedly" occurring. They are described as "highly structured," "elaborately engineered," and "manipulative." The regulatory effort admits the distinctions sought to be drawn are difficult, so whence the moralistic fervor of the prose? And the effort admits that good transactions underwritten by valid business purpose might be sacrificed to the cause. This seems wrong, as noted above, but at a minimum the taxpayers asked "to take one for the team" should not be demeaned.

Overheated prose (or not, depending on one's point of view) is not a big issue. But it introduces an important query. Has the zeal to attack "elaborately engineered" and "manipulative" transactions clouded the reasoning offered in support of the effort? Is the whole effort guilty of the logical fallacy of "petitio principii," sometimes translated as begging the question. Faulty reasoning of this sort occurs when the arguments offered in support of a conclusion are in fact derivatives of a conclusion already reached. The conclusion already reached here is that abusive foreign tax credit transactions exist. The proofs then offered do not of themselves support this conclusion, but rather describe circumstances either wholly innocent absent the overall conclusion already reached, or themselves in need of proof as abusive. For example, the very first sentence of the relevant preamble, as codified in condition (3) of the proposed regulation, offers as proof of abuse a circumstance wherein more tax is paid in a foreign jurisdiction *than would be paid if there were no business whatsoever done in that foreign jurisdiction.* Is this not a truism, rather than an abuse? Is it not always the case that one will pay "significantly less, or even no" tax in a foreign country, as the preamble would have it, if one has *no connection whatsoever to that country?* Might this circumstance be explained purely by tax indifference? Thus, "I chose to buy French mortgage securities in France because the French and U.S. corporate tax rates are roughly equivalent." Or, more likely, might it be explained by tax indifference and sound business purpose. Thus, "I have a large staff in my existing Paris office that knows the underlying real estate and the complicated French rules on securitization; my Paris shop also serves as my site in Europe where I hedge the Euro." If confronted by the accusation that doing this business in Paris instead of New York is indicative of abuse, can't one assume the answer? That is, won't the answer be, "New York is a high tax jurisdiction, makes due diligence on the underlying property difficult, makes access to EU lawyers and IAS accountants difficult, and makes no sense whatsoever. When did the U.S., the great proponent of free trade and globalization, get protectionist about its tax revenue?"

Protectionism is another underlying theme of the proposed regulation, by the way. Condition (3), already noted, is an obvious example. It asks the question, could one avoid the foreign tax in question by doing one's business in the U.S.? If the answer is that one could, but did not, one of only two real tests conditional to a finding of abuse will have been satisfied. I personally am interested most in what the regulations describe as U.S. borrower transactions, as noted above. The long example in the preamble of such a transaction treats as a damning factor that the transaction is not beneficial "on a pre-tax U.S. tax basis." Further below I will revise the example and illustrate a case that should be impervious to challenge. I will leave the "SPV" in the example as a CFC. But if I were to change the SPV to a check-the-box branch, the example would be positive "on a pre-tax U.S. tax basis." Is this dispositive? Is it even relevant? If one is considering business purpose, isn't the proper question whether the transaction is pre-tax positive on a system or enterprise basis? Perhaps the policy decision was deliberate, but the regulations do seem to treat the financial institutions at which they are aimed as the equivalent of the "runaway manufacturing plants"

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of long ago deferral debates. I harbor no illusion that the tiny part of the world represented by these regulations is worthy of the consideration given immigration, outsourcing, and the like, but philosophically and intellectually these regulations would make Bill O'Reilly and Lou Dobbs proud.

So, having used "silly," "ostensible," and, worse, Lou Dobbs and Bill O'Reilly, it's time to tone down my own rhetoric and turn to a few technical points.

I assume everyone will note that there are only two real conditions defining abusive in this context — a foreign tax benefit concurrent with the claiming of a U.S. foreign tax credit and inconsistent treatment. But shouldn't there be some causality between the two? Shouldn't the inconsistent treatment cause the concurrent tax benefits? This does not appear to be required. The only causality clearly required is within the inconsistent treatment condition. That is, hybrid treatment must affect the amount of income recognized or credits claimed in the U.S. However, any check-the-box of a foreign entity — whether to corporate status or transparency — will affect the amount of income recognized in the U.S. Then, a counterparty in a financial joint venture may also realize a typical tax benefit, such as an interest deduction or depreciation unrelated to the inconsistent treatment. It may be that the phrase in condition (4), " . . . is structured in such a manner that it results . . . ", means "causes." If so, could this be made clearer, please.

Next, I assume many also will assert that the existing "compulsory tax" regulation was a poor place from which to launch this reform. The proposed regulation's line of argument — that the transactions in issue were planned, therefore they were voluntary, therefore the tax paid was non-compulsory — is questionable. Dismissing the freedom to choose one's place of organization, level of capitalization, and form of transaction — explicit in existing law — is even harder. My comment here is different. Foreign taxes are creditable under both the statute and by treaty. The foreign taxes the proposed regulation makes non-creditable are often specifically named as creditable in a treaty. Yes, the U.S. reserves the right to apply its view of domestic law before applying a treaty, and in the "compulsory tax" area it has held that certain over-withheld taxes, albeit otherwise creditable by treaty, were not. That determination went to the true intent of the compulsory regulation, however — whether someone was properly determining and paying the tax exacted at law. Here the "improper determination" results simply from choosing to do business in a foreign country, rather than in the U.S. That is, choosing to do business in a foreign country constitutes the voluntary action that makes a tax otherwise properly determined, exacted at law, and *expressly creditable by treaty,* non-creditable. Admittedly, this is another criticism of condition (3) and the protectionist underpinnings of the proposed regulation, but do our treaty partners recognize that choosing to continue or create a permanent establishment in their country — the reason to have a treaty in the first place — might displace application of the treaty?

Finally, the transactions deemed abusive are so tagged in part because they involve "passive" income. It is submitted that section 954(c) is an inappropriate determinant of passivity here, and as a corollary that section 954(h) reflects a very limited view of "active." Section 954(c) goes to eligibility for deferral, and does not speak in terms of active versus passive. In fact, it must not, because "interest" is included in section 954(c) but is the stock in trade of a bank — that is, it is the active income a bank typically seeks to earn. So, although the prototypical income of a bank may not be eligible for deferral, per the decision of Congress, it is still the active income of that business. Section 904 and the regulations issued thereunder recognize this. Thus, before the 2004 Act, income from the active conduct of a banking business was placed in the financial services basket, as opposed to the passive income basket. Now such income is placed in the general basket, but still not the passive income basket. Accordingly, it is submitted that section 904(d)(2) and the existing § 1.904-4(e) regulations would better distinguish active from passive income in this context. And please don't offer section 954(h) as a substitute. It is special interest legislation originally passed to assist three credit corporations, and it is frequently in danger of expiring. Since it was never intended to cover all, it is, frankly, a mess. And it very much does not reflect current forms of business organization. Who, for example, is vertically integrated by country anymore? And in an EU-type world, why should one be expected to earn 30% of one's income from customers resident in a single country?

The preamble summarizes its views via examples, so perhaps it is appropriate to do the same. What follows is the preamble's example of a U.S. borrower transaction, revised slightly to reflect a real world situation:

> "For example, assume that a U.S. financial institution can borrow $1.0 billion from a foreign counterparty. The U.S. borrower has a corporation (CFC) in the same country as the foreign counterparty. The U.S. borrower in a previous year borrowed $1.5 billion in the U.S. and contributed it to CFC in exchange for 100 percent of the common and preferred stock of CFC. CFC, in turn, had loaned the entire $1.5 billion to a number of third party foreign customers in furtherance of its existing business as a financial institution. The U.S. borrower

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transfers the preferred stock of CFC to the foreign counterparty for $1.0 billion, subject to an obligation to repurchase that stock in five years for $1.0 billion. The U.S. borrower uses the $1.0 billion to pay off $1.0 billion of its higher cost U.S. borrowing. CFC continues to earn $120 million of interest income from its third party loans, as it has in prior years. CFC also continues to pay $36 million of foreign tax, as it has in prior years. After the loan to its parent by foreign counterparty, however, CFC distributes the remaining $84 million to the foreign counterparty.

For U.S. tax purposes, the sale-repurchase transaction constitutes a borrowing by the U.S. financial institution secured by the CFC preferred stock. Accordingly, the U.S. borrower owns the stock of CFC for U.S. tax purposes and has an outstanding debt obligation to the foreign counterparty. The U.S. party reports the distribution from CFC as its dividend income and claims indirect credits under section 902 for the $36 million of foreign taxes paid by CFC, as it has in prior years. That is, it includes in income the cash dividend of $84 million paid to the foreign counterparty, plus a section 78 gross-up amount of $36 million, for a total of $120 million. The U.S. borrower claims a deduction of $84 million as interest on its debt obligation to the foreign counterparty. The CFC reduces its E&P by $120 million. In summary, the U.S. borrower claims a foreign tax credit of $36 million — as in prior years — and an interest expense deduction (net of income inclusions) of $84 million — less than was claimed in prior years with respect to U.S. borrower's higher cost U.S. debt.

For foreign tax purposes, the foreign counterparty owns the equity of CFC and is not subject to additional foreign tax upon receipt of the "dividend." The net result is that the foreign jurisdiction continues to collect foreign taxes on the financial business of CFC, as it has in the past, but foregoes taxation of the foreign counterparty that would be expected on a direct loan.

Both parties benefit from the arrangement. The foreign lender obtains an after-foreign tax interest rate that is higher than the after-foreign tax interest rate it would earn on a direct loan. The U.S. borrower's funding costs are lower on a pre- and after-tax basis. It has simply used the dividend income from CFC it was otherwise receiving to pay its interest expense to foreign counterparty.

The benefit to the parties is solely attributable to the conversion of interest income taxable to the foreign counterparty to exempt dividends not taxable. The U.S. fisc benefits, because of the reduced interest deduction claimed by U.S. borrower. The foreign jurisdiction loses because the amount received by foreign lender, which would have been taxable if structured as a direct loan, is exempt from foreign tax. The tax paid by CFC to the foreign jurisdiction continues at exactly the same level as paid in years past."

> ***What is abusive about this transaction? The answer is absolutely nothing.***

What is abusive about this transaction? The answer is absolutely nothing. In fact, taxpayers in excess tax credit positions have done it, because they were paying the foreign tax in any event on a business appropriately conducted abroad, and because they appreciated the cheap funding the foreign repo loan could provide. This example, as revised, embodies many of the comments made above — that taxpayers conduct business abroad for valid business reasons, that they do not do so to generate foreign tax credits, that the absence of a disproportionate credit test will produce anomalous results, and that some so-called "passive investment arrangements" decrease U.S. deductible expenses, increase pre-tax profits, and benefit the U.S. fisc. So, it is fair to ask, how will the final regulations deal with this example?

* * * * *

Despite the foregoing and the comments of others, if the Government is intent on denying foreign tax credits in this context on an end-result basis, as others have charged, or if the Government does not have the patience to craft a business purpose exception or the tolerance to accept that some bad transactions may continue as a result, the end-result "reform" intended can be achieved with less violence to existing law. That is, the Government need not contend that the choice of one's place of organization or form of transaction can render a properly determined tax, exacted at law, non-compulsory. Nor need the Government finesse its treaty obligations. Instead, for example, existing Reg. § 1.861.1-10T could be amended so as to allocate all relevant income expense of a group directly against the foreign source income produced by a "passive investment arrangement" (albeit better defined). This would recognize that the real "voluntariness" in this context is the choice to incur indebtedness in the U.S. while at the same time capitalizing a foreign operation solely with equity. As a result, foreign profits subject to foreign tax are not reduced by interest charges. (The foreign operation is, so to speak, too "thickly" capitalized.) Such a change also would

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recognize that the U.S. already has in place a comprehensive regime meant to address "back leverage" and other expenses incurred in the U.S., at the expense of increased foreign taxes.

Alternatively, the existing preamble's discussion of the avoidance of double taxation as the foundation of the foreign tax credit could be expanded to note that relief from double taxation is not necessary where one is able to achieve economic relief through monetization of the foreign tax. This could be combined with a revision of the existing subsidy regulations. For example, Reg. § 1.901-2(e)(3)(i)(A) could be rewritten, "The amount is used or permitted to be used, directly or indirectly, by the tax laws of the foreign country imposing the tax to provide a subsidy . . ." And Reg. § 1.901-2(e)(3)(ii) could be revised to read, "The term subsidy includes any benefit conferred on any of the parties enumerated in paragraph (e)(3)(A) of this section as a result of the operation of the tax laws of the foreign country imposing the tax." Examples could then be added. In the case of a U.S. borrower transaction, a shortened version of the example given above could be outlined, the participation exemption afforded the foreign lender noted as the subsidy, and the reduced borrowing cost of the U.S. group cited as rendering unnecessary, economically, relief from double taxation.

The foregoing suggestions are not meant to be perfectly crafted; that is the job of the rulemakers. More importantly, the foregoing suggestions assume that the final regulatory effort will remain end-result based. In any event, whether the intended result is achieved by way of 861-8, the subsidy regulations, or the compulsory tax regulations, the final effort should be prospective. An appropriate transition rule could apply the final regulations to any new transaction closed on or after March 29, or transactions existing on March 29 that are substantially modified thereafter. With respect to transactions existing on March 29 and not modified thereafter, the final regulation should apply from the first day of the first taxable year beginning after March 29 or the date the regulation is made final, as the Government decides is most appropriate, so as to permit alternate financing to be arranged, breakage to be avoided, swaps to be terminated, and the like — and so as to acknowledge that the end-result achieved is not apparent in existing law. ◆

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