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June 26, 2007

Via Federal Express

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

JUL 2 2007

Internal Revenue Service
CC:PA:LPD:PR (REG-156779-06)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Proposed Regulation for Determining the Amount of
Taxes Paid for Purposes of Section 901 (REG – 156779-06)

Ladies and Gentlemen:

We appreciate the opportunity to comment on the proposed regulation (the "Proposed Regulation") issued on March 30, 2007, which seeks to provide guidance with respect to the application of section 1.901-2(e)(5) when a U.S. person owns interests in one or more foreign entities and is a party to certain passive investment arrangements.

1. Background

The preamble to the Proposed Regulation indicates that certain arrangements which are between a U.S. taxpayer and an unrelated foreign counterparty violate the purpose of the foreign tax credit because they are structured in a way that subjects the arrangement to foreign taxes, thereby generating foreign tax credits in a manner that allows the parties to obtain duplicate tax benefits and share the cost of such foreign tax payments, when a more direct arrangement that would limit or eliminate foreign tax was available (albeit with a lower rate of return).

The Proposed Regulation takes the position that foreign taxes paid with respect to these arrangements are "voluntary" and hence do not qualify for the foreign tax credit. We strongly disagree with this analysis. Payments of foreign taxes with respect to these arrangements can by no stretch of imagination be viewed as "voluntary". If a taxpayer adopts a business or investment structure under which income is subject to tax under foreign law, the resulting tax payments are compulsory and to say otherwise flies in the face of logic and common sense.

The preamble and the Proposed Regulation indicate that the primary concern the Internal Revenue Service has with respect to these passive investment arrangements is that (i) the U.S.

taxpayer voluntarily engages in a transaction outside of the U.S. taxing jurisdiction for a "fee" (generally in the form of an enhanced return on investment) which has its origins (or part of its origins) in a foreign tax benefit derived by a foreign counterparty, and (ii) this movement offshore is "subsidized" by the U.S. Treasury to the extent the transaction could have occurred onshore and been subject solely to U.S. tax.

The question at issue is whether the Internal Revenue Service has addressed this concern in an appropriate manner. We submit that it has not. Saying that a foreign tax is "voluntary" and hence not creditable merely because a taxpayer voluntarily adopted a business or investment structure that results in a foreign tax liability is wrong as a matter of fact and law. The payment of foreign taxes under these circumstances is not "voluntary". There is a legal liability under foreign law for the payment of the foreign taxes. Some person will most likely go to jail or be penalized if these taxes are not paid. If the foreign tax credit is not available whenever a taxpayer voluntarily sets up a business or investment operation in a foreign country and thereby submits itself to that country's tax jurisdiction, the credit will no longer exist.

2. Purpose of the Foreign Tax Credit Provisions

The creation and development of the U.S. foreign tax credit system ("FTC provisions") has been aptly described as entailing a combination of principled idealism, national self-interest, and political and administrative practicality.[1]

The FTC provisions were enacted in 1918 to redress double taxation of foreign-source income that could otherwise result from a system in which taxpayers are taxed on their worldwide income.[2]

In 1921, a limitation was introduced on the foreign tax credit to ensure that a taxpayer's total foreign tax credits could not exceed the amount of the U.S. tax liability on the taxpayer's foreign-source income.[3] The limitation was intended to prevent the use of the foreign tax credit to shelter domestic income from tax and to confine its role to avoiding double taxation of international transactions.

While the details of the foreign tax credit (particularly in the area of the limitation) have changed substantially since its introduction, these provisions still constitute the basis and foundation for taxing income earned abroad by U.S. citizens and residents.

The enactment of the foreign tax credit provisions was considered necessary to alleviate the burden of double taxation imposed on U.S. residents that earned their income abroad.

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[1] The National Foreign Trade Council – Report and Analysis on International Tax Policy for the 21st Century, December 15, 2001.

[2] Revenue Act of 1918, ch. 18, 40 Stat. 1057, §§ 222(a)(1) (individuals), 238(a) (corporations), 240(c) (describing creditable taxes).

[3] Revenue Act of 1921, ch. 136, 42 Stat. 227, §§ 222(a)(5) (individuals), 238(a) (corporations).

According to Professor T.S. Adams, the Treasury's tax expert who proposed the foreign tax credit to Congress, it was this lack of fairness and equity that facilitated the enactment of the proposal into law.[4] Importantly, the passage of the law was an acknowledgment that a significant portion of the inequity was caused by the country of residence also endeavoring to tax income over which a foreign jurisdiction had a priority if not superior claim.[5]

The enactment of the foreign tax credit was also aimed at encouraging private investment by Americans abroad (at that time particularly in Europe). The foreign tax credit was viewed as a deliberate indirect subsidization by the government of the growth and expansion of U.S. business interests abroad. The Congressional attitude was summed up as follows by an international tax attorney who worked as an assistant to Professor Adams:

> The American credit system is ideal for a wealthy country that desires to encourage the expansion of its foreign trade, and is willing to afford relief from double taxation to its own citizens or residents...The United States says, in effect, to its citizens—go abroad and trade. If you have to pay tax on your earnings in foreign countries, show me your tax bill and I will give you relief....[6]

The FTC provisions recognized that, subject to the overall limitation in section 904, a U.S. taxpayer must be treated equitably regardless of its source of income and be provided (at its election) with a credit for foreign taxes paid or accrued with respect to its foreign source income. Congress wanted the tax system to be neutral with respect to foreign investment decisions. Congress viewed the foreign tax credit as a device to ensure that foreign investment would not be discouraged by double taxation.

3. Overview of Section 901 and Section 1.902(e)(5)

The FTC provisions permits a taxpayer paying foreign income taxes to credit such taxes against its U.S. income tax liability, subject to the rules of sections 901 through 908.

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[4] *See* T. S. Adams, International and Interstate Aspects of Double Taxation, NAT'L TAX ASS'N PROC. 193, 198 (1929).

[5] "Every state insists upon taxing the non-resident alien who derives income from sources within that country, and rightly so, at least inevitably so. Now, then, in due course of time, citizens of the home state inevitably invest abroad and derive income from foreign sources. The average state refuses to acknowledge in this situation the right of its own citizens to a proper exemption on income derived from foreign sources...[I]t refuses to recognize when one of its own citizens or nationals gets income from a foreign source that he inevitably will be taxed abroad." *See* T. S. Adams, International and Interstate Aspects of Double Taxation, NAT'L TAX ASS'N PROC. 197-198 (1929).

[6] Mitchell B. Carroll, Double Taxation Relief, Discussion of Conventions Drafted at the International Conference of Experts, 1927 and Other Measures, DEPARTMENT OF COMMERCE TRADE INFORMATION BULLETIN NO. 523, 1 (1927).

Section 901(a) provides in relevant part that:

> If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960.

Section 901(b)(1) provides subject to the limitation of section 904 that the following amounts shall be allowed as the credit under subsection (a):

> In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States.

Accordingly, subject to the limitation in section 904, section 901 mandates the availability of a credit at the election of the taxpayer for any income tax paid or accrued to a foreign country. The regulations issued to date in respect of the provisions of section 901 are limited to (1) identifying and distinguishing foreign income, war profits or excess profits tax from other foreign levies, (2) identifying the proper amount of foreign tax paid or accrued and (3) ensuring that the credit is available only for taxes properly due under foreign law.

The regulations, generally, provide that the payment of a foreign levy is creditable only if the levy constitutes a "tax" as determined under principles of U.S. law. In endeavoring to identify what constitutes a foreign tax, section 1.901-2(a)(2)(i) indicates that a foreign levy qualifies as a tax only if its payment is compulsory and if the levy is imposed pursuant to the taxing authority of a foreign government.

Section 1.901-2(e)(5) provides that a payment is compulsory only if the amount paid does not exceed the amount of the liability, properly computed, under foreign law.[7] The liability must be computed in a manner consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law and the taxpayer must demonstrate that it has exhausted all effective and practical remedies (including competent authority relief) to reduce its foreign tax liability.

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[7] The principles of a "compulsory" payment derive from case law under section 164 (relating to deductions for state and local taxes) which held that a deduction for a tax payment will be disallowed when there is no legal liability for such payment. *See Cooperstown Corp. v. Commissioner*, 144 F.2d 693, 694 (3d Cir. 1944) – "Even had no claim for refund been made or as yet allowed, it would, none the less, have been within the Commissioner's power, the return still being open to review, to disallow the deduction for the payment for which there was no legal liability resting upon the taxpayer. In order to isolate a payment or an accrual of a liability as a completed transaction in the year in which it is made or accrued, it is necessary that the taxpayer be under a legal obligation for the payment at the time it is made or accrued." *See also, Kenyon Instrument Co. v. Commissioner*, 16 T.C. 732, 741 (1951). The principles of Cooperstown and Kenyon were extended to the area of foreign tax credits by administrative rulings and cases. For example, *see Rev. Rul. 77 – 267.*

The examples incorporated in section 1.901-2(e)(5)(ii) to illustrate the above principle generally envisage a taxpayer that either miscalculates its foreign tax liability or fails to pursue administrative or judicial remedies to obtain a refund for all or part of the foreign tax paid when it is entitled to receive such a refund.[8] Consistent with the literal wording of the regulations, the application of the compulsory tax rules has been triggered by actions or omissions that increase or fail to decrease a variable foreign tax as applicable to the taxpayer's assets or business operations but not by a voluntary decision to subject such business or assets to foreign tax. No case has held or even suggested that a foreign tax credit should be denied because a taxpayer voluntarily submitted its operations to a foreign country's tax jurisdiction.

Importantly, section 1.901-2(e)(5) in relevant part provides that a taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its tax liability under foreign law. This regulation only comes into play once the decision to move offshore has been made. It seeks to ensure that a U.S. taxpayer does not become "anesthetized" to the payment of foreign taxes on the basis that those taxes are creditable against his U.S. tax liability.

Under current law and regulations, taxpayers are generally free to choose the location (U.S. vs. foreign) and form (e.g., corporation or pass-through entity) in which they organize their business and investment activities.[9] As Judge Learned Hand said over 70 years ago "any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes".[10] The following paragraph from a treatise on the creditability of foreign taxes succinctly summarizes the current position of the law on the matter of business structures:

> [Furthermore], the U.S. taxpayer's liability for foreign tax is determined by taking into account its form of doing business, its business conduct and the form of any business transactions. If, for example, the taxpayer operates as a locally incorporated corporation, it would be considered to have liability for whatever tax is imposed on local corporations, even if less tax would be paid if the taxpayer operated in the foreign country as a branch of a U.S. corporation or alternatively if it was part of a foreign *consolidated* group. Furthermore, the fact that the taxpayer would pay less foreign tax if fewer activities were performed within the foreign jurisdiction is irrelevant. No alteration of the taxpayer's business conduct or of the form of business or of a transaction is required. (Citations omitted).[11]

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[8] *See* Regs. section 1.901-2(e)(5)(ii) Examples (1) through (6).

[9] *See*, e.g., Regs. section 301.7701-3(a); section 1.701-2(d) Examples (1) - (4); section 1.701-2(f), Example (3), section 1.901-2(e)(5)(i).

[10] *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), aff'd sub nom. *Gregory v. Helvering*, 293 U.S. 465 (1935).

[11] 901- 2nd T.M. *The Foreign Tax Credit – Overview and Creditability Issues by Carolyn M. DuPuy and D.Kevin Dolan. page A-44.*

The Internal Revenue Service has always analyzed the question of whether a foreign payment is "compulsory" for purposes of section 1.901-2(e)(5) within the context of a taxpayer's business decision. For example, Field Service Advisory 200049010 (December 11, 2000), involved a situation in which the U.S. taxpayer was a corporation with a Danish subsidiary. Denmark permitted certain locally incorporated subsidiaries to elect to pay their corporate income taxes on either an "on-account" method or a "traditional" method. The latter method generally involved a later payment of the tax and companies electing this method were required to pay a surcharge. The IRS concluded that the surcharge did not constitute a tax that entitled the parent to an indirect foreign tax credit because it was paid voluntarily (since a corporation could avoid imposition of the surcharge by electing the "on-account" method). In arriving at this conclusion the IRS observed as follows:

> Treasury Regulation section 1.901-2(e)(5)(i) provides that a taxpayer is not required to alter: (1) its form of doing business; (2) its business conduct; or (3) the form of any business transaction, in order to reduce its liability under foreign law for tax. Under the facts of this case, in order for Sub to reduce its tax liability, **it is not necessary for it to alter its form of doing business, its business conduct, or the form of its business transactions**. In order for Sub to reduce its reasonably expected tax liability as required under Treas. Reg. section 1.901-2(e)(5), it must avoid imposition of the 11.75% surcharge by altering the timing by which it makes its corporate tax payments to Denmark, thereby paying its liability in full prior to when its liability for the surcharge becomes fixed. **Requiring Sub to alter its method of paying its Danish tax liability in order to avoid the 11.75% surcharge does not entail altering any of the three above enumerated categories.** (Emphasis added).

It is clear that the conclusion that the surcharge was a voluntary tax would not have prevailed if the taxpayer had been required to alter its form of doing business or its business conduct to avoid it.

In Chief Counsel Advisory 200532044 (May 5, 2005), which involved a multi-step financing transaction, the issue was whether a dual resident company (resident in the U.S. and Country X) was required to request that the competent authorities resolve its dual-resident status pursuant to the "residence" article of the U.S. – Country X tax treaty. The CCA acknowledged that the dual resident entity chose to subject itself to Country X tax for the purposes of the financing transaction, but it concluded that the Country X tax paid was voluntary because the failure to pursue competent authority resolution of the taxpayer's dual-resident status meant that there had been a failure to exhaust the effective and practical remedies that were available.

The approach taken by the present regulations and the rulings is not surprising. It is consistent with and properly reflects Congressional intent with respect to the creditability of foreign taxes and the impact the foreign tax credit provisions should have on investment decisions. The purpose of the foreign tax credit was to give relief from double taxation. There was no intention to regulate business decisions.

4. The Proposed Regulation

The Proposed Regulation seeks to amend section 1.901-2(e)(5) to provide that foreign tax payments attributable to a passive investment arrangement that meets a six criteria test will not be considered compulsory payments for U.S. tax purposes and will therefore not be creditable notwithstanding that (1) the foreign taxes paid or accrued are income taxes within the meaning of section 901 and the regulations thereunder, and (2) such taxes are paid pursuant to compulsion of foreign law.

Although section B1 of the preamble and the examples quoted therein, which are replicated in sections 1.901-2(e)(5)(iv)(D) of the Proposed Regulation (particularly Examples 1, 4 and 7), indicate that there must be certain other "abusive" elements associated with structured passive investment arrangements, such as a duplication or hyping of tax benefits/credits and the use of such benefits/credits to shelter income of the U.S. taxpayer that is unrelated to the transaction, this requirement is not carried over into the six criteria test. The six criteria test gives no weight to the intent of parties or the substance of the transaction or the presence or absence of the abusive features referred to above and it seems clear that a structured passive financing arrangement will be found even in the absence of any such abusive elements. The Proposed Regulation disregards factors such as the economic substance and business purpose doctrine (the preamble acknowledges that often there is a business purpose for the financing or portfolio investment underlying an arrangement), as well as the criteria set out in Notice 98-5 (notwithstanding its withdrawal) and existing regulations that taxpayers have relied upon (in the absence of other clear guidance) in getting comfortable that certain financing transactions generally entered into in the ordinary course of business could be embarked upon without the risk of being considered suspect from a tax perspective.[12]

5. Discussion

The Proposed Regulation seeks to prevent certain arrangements by characterizing as "voluntary", payments of taxes that are required by foreign law. This is wrong as a matter of fact and law. The tax payments discussed in the Proposed Regulation are not "voluntary". They are compulsory. There is no dispute that the taxes are income taxes and that a legal liability exists under foreign law for their payment. If the taxes are not paid, penalties will be imposed and people run the risk of being jailed. A voluntary decision to locate a business or investment

[12] As currently proposed, the regulation would apply equally to a transaction that demonstrates economic substance and business purpose, (e.g. a transaction that projects average annualized yields that are comparable to what international investors similarly placed to the U.S. taxpayer would anticipate earning on investments of a similar character and risk profile), as well as to a transaction that is wholly driven and/or motivated by U.S. tax considerations. The Proposed Regulation would deny foreign tax credits associated with taxes paid or deemed paid by a U.S. taxpayer even in a situation in which the generation of foreign tax credits was merely ancillary to the business purpose surrounding the transaction and the economic profits of the transaction overshadowed the foreign tax credits generated.

operation in a foreign country does not make tax payments mandated by that country's laws voluntary. No court has so held and the Internal Revenue Service has never so contended.

The denial of a credit for foreign income taxes that have been properly computed and paid by a U.S. taxpayer on its foreign source income is not permitted by the statute. Section 901 allows a credit for **any foreign income taxes** paid or accrued. It does not allow the Internal Revenue Service to deny a credit for income tax paid under compulsion of foreign law because the taxpayer's decision to operate in a foreign country made the tax voluntary.

If the Treasury and the IRS believe that the FTC provisions are being abused by the investment arrangements that are the subject of the Proposed Regulation they may apply well-established judicial doctrines such as the business purpose and economic test or they may go to Congress. They have no power to deny the credit on the ground that an income tax payment made under compulsion of foreign law is voluntary. That proposition we reiterate is wrong in fact and in law.

6. Conclusion

The Proposed Regulation is contrary to the FTC provisions and should be withdrawn.

Sincerely,

Peter L. Faber

Kumar Paul