# International Arbitrage Transactions Involving Creditable Taxes

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# I. Introduction

In general, international tax arbitrage arises when a taxpayer or taxpayers rely on differences between the tax rules of two countries to structure a transaction, entity or arrangement in a manner that produces overall tax benefits that are greater than what would arise if the transaction, entity or arrangement had been subject only to the tax rules of a single country.[1]

Excluded from the scope of international tax arbitrage, at least for purposes of this paper, are situations involving an incorrect or improper application of the tax laws of any country, transactions in which the taxpayers take inconsistent factual positions in their respective countries and other cases that are more appropriately viewed as abusive tax shelters. In other words, this paper deals with international arbitrage transactions involving creditable taxes that work under current law (or at least that worked as of December 15, 2006), and considers the tax policy issues that they raise.

The foreign tax credit (the "FTC") plays a significant role in many transactions and structures that fall within the general rubric of international tax arbitrage. This paper is premised on the notion that it is worthwhile to focus on FTC-related arbitrage transactions and structures because (i) an appreciation of the policies and rules relating to the foreign tax credit is necessary to properly consider the issues raised by, and possible approaches to, such transactions and structures and (ii) focusing on FTC-related arbitrage transactions can provide broader insights regarding international tax arbitrage generally. We are fortunate to be discussing these dual perspectives with the benefit of the comprehensive catalogue of the various categories of international arbitrage transactions and the refreshingly pragmatic framework to assessing such transactions that Greg May's article[2] has provided.

Part II describes two general categories of FTC-related arbitrage transactions and structures that have received a considerable amount of attention. The first category involves structures in which the foreign tax credit is separated from the tax base to which it relates, whether under the consolidated tax regimes of particular countries, the use of reverse hybrid entities, the use of hybrid securities, or other techniques, so that the taxpayer can benefit from the credit without having to include the related income ("FTC separation structures"). The second category involves transactions that permit the effective duplication of tax benefits in two countries ("duplicate benefits FTC arbitrage transactions"), usually because the United States treats the U.S. participant as the owner of the entity that pays the foreign income (or withholding) tax and allows it a foreign tax credit while a foreign country treats the non-U.S. participant as the owner of the entity for purposes of its tax law. By way of comparison to duplicate benefits FTC arbitrage transactions, Part II also describes "reverse FTC arbitrage" transactions, in which the entity pays U.S. net income tax and the U.S. participant benefits from such tax payment by not having to pay additional U.S. tax in respect of its

share of the entity's income (for example as a result of the dividends received deduction (DRD)[3] or consolidation rules[4]), while the foreign participant claims a foreign tax credit for the U.S. taxes in its home country. Also by way of comparison to duplicate benefits FTC transactions, Part II describes transactions in which an entity pays U.S. withholding tax that is claimed as a credit by both the U.S. participant and the foreign participant in their respective countries.

The arbitrage transactions and structures that are described in Part II share a number of common features. They typically employ one or more similar techniques and navigate through a maze of common rules, some of which are described in Part III. These include techniques that permit both the U.S. participant and the foreign participant to be treated as the owner for tax purposes under its home country's tax rules, such as "sale and repurchase" (or "repo") agreements and variations thereon. Another common technique utilizes hybrid securities, which are treated as equity for purposes of one country's tax rules but as debt for purposes of another country's tax rules. Yet another technique is to use hybrid or reverse hybrid entities, which are treated as tax-transparent in one country but as a taxpaying entity in another; this technique is of course facilitated by the U.S. "check-the-box" (CTB) entity classification election rules.[5] In addition, particular types of arbitrage transactions and structures rely on the interpretation and application of very technical rules, including those relating to the foreign tax credit limitation under Code Sec. 904, the allocation of interest and other expenses, partnership allocations, *etc*. Such transactions and structures also must pass muster under general principles such as the economic substance, business purpose, substance over form and step transaction principles.

Part IV summarizes the policies, conditions and limitations of the foreign tax credit. Part V examines some of the broad policy issues raised by international tax arbitrage transactions, and in particular, proposes an approach for addressing the ultimate question of whether there is anything wrong with these transactions, and if there is something wrong, what exactly is the problem.

Part VI then considers whether and, if so, in what respects, FTC-related arbitrage transactions are problematic as a policy matter, drawing upon the policies underlying, and rules implementing, the foreign tax credit that are outlined in Part IV and the framework for evaluating international tax arbitrage transactions that is proposed in Part V. As discussed in Part VI.A below, FTC separation structures appear to be troublesome because they effect an artificial and indefinite mismatch between creditable taxes and the related tax base and are therefore inconsistent with the policies underlying the foreign tax credit (including the matching principle and the capital export neutrality principle) as well as the arm's length principle of Code Sec. 482. On the other hand, for the reasons summarized in Part VI.B.12 below, duplicate benefits FTC arbitrage transactions implicate a considerably more complex and mixed set of policy considerations, and—putting aside a few problematic exceptions—it is not clear whether or to what extent these transactions (or subcategories thereof) should be curbed as a policy matter.

Part VII discusses various approaches that may be considered to address FTC-related arbitrage transactions in the event that Congress, the Treasury Department or the Internal Revenue Service (the "IRS") conclude that it is appropriate to do so. Depending on the nature of the perceived problem to be addressed, implementing a solution may be either relatively straightforward or may pose formidable challenges, especially in delineating between "good" and "bad" transactions.

Finally, Part VIII provides some concluding observations regarding FTC-related arbitrage transactions and, more generally, international tax arbitrage. The most salient observations are that (i) in evaluating and responding to international tax arbitrage transactions, one size does *not* fit all; rather, a flexible factors-based analysis of each particular category seems to be required in order to properly reflect and weigh the policy and practical implications presented by that category, and (ii) to a considerably greater extent than might have been imagined, it appears that the crux of the issues and solutions will typically be U.S. tax–centric, and that bilateral or multilateral solutions will generally not be necessary or efficient to implement, although there is a very important role for coordination between the Treasury/IRS and other tax authorities in identifying and combating abusive transactions.

# II. Description of Transactions and Structures

## A. FTC Separation Structures

The first category of FTC-related arbitrage transactions and structures that will be discussed in this paper involves structures that are employed by multinational corporations (and, less frequently, by other investors)

to separate the foreign tax credit from the tax base to which it relates, so that the taxpayer can benefit from the credit without having to include the related income. This result can be achieved—at least prior to the January 1, 2007, effective date of proposed Reg. §1.901-2(f)[6]—under the consolidated tax regimes of particular countries as well as through the use of reverse hybrid entities, hybrid securities or other techniques.

**Example 1. Consolidated Tax Regime**. U.S. Parent owns Luxembourg holding company ("Lux Holdco"), which in turn owns three Luxembourg operating subsidiaries ("Lux Opcos"). For U.S. tax purposes, Lux Holdco is a disregarded entity while the Lux Opcos are corporations. Lux Holdco and Lux Opcos are taxed in Luxembourg under the fiscal unity group rules, pursuant to which Lux Holdco has sole legal liability for the tax of the members of the fiscal unity group.

Example 1 is similar to the facts in *Guardian Industries Corp.*,[7] where the court held that under the Luxembourg fiscal unity group rules, Lux Holdco indeed has sole legal liability for the tax of the members of the fiscal unity group. The court concluded that under the relevant U.S. tax rules (discussed in Part IV below), "the person on whom foreign law imposes legal liability is the person by whom the tax is considered paid, for Code Sec. 901 purposes,"[8] so that Lux Holdco is treated as having paid the group's Luxembourg tax for U.S. tax purposes. Since Lux Holdco is a disregarded entity, the tax is deemed to have been paid by U.S. Parent, which can claim a foreign tax credit under Code Sec. 901. However, because the Lux Opcos are corporations for U.S. tax purposes, their earnings will not be currently includible in U.S. Parent's income. As a result, if U.S. Parent is in an excess limitation position, it can utilize the foreign tax credits from Lux Holdco to shelter other foreign source income in the same Code Sec. 904 category from U.S. tax.[9]

**Example 2. Reverse Hybrid Structure**. U.S. Parent owns a Country X holding company ("Holdco"), which in turn owns Country X operating subsidiaries ("Opcos"). Opcos are organized as reverse hybrid entities, so that they are treated as corporations for U.S. tax purposes but as transparent entities for Country X tax purposes. Therefore, for Country X tax purposes, Holdco includes the income of the Opcos and pays Country X tax in respect of such income.

If Holdco is a disregarded entity for U.S. tax purposes, U.S. Parent would be treated as having paid the Country X tax and would be eligible to claim a foreign tax credit under Code Sec. 901 but would not need to include the Opcos' earnings (unless they are distributed).[10] Alternatively, if Holdco is a corporation for U.S. tax purposes, U.S. Parent would be eligible to claim a foreign tax credit under Code Sec. 902 when it receives a dividend from Holdco, but would not need to include the Opcos' earnings (unless they are distributed).[11]

**Example 3. Hybrid Securities Structure**. U.S. Parent owns Country Y corporation 1 ("Corp1"), which in turn owns Country Y corporation 2 ("Corp2"), both of which are corporations for U.S. and Country Y tax purposes. Corp1 holds a hybrid security of Corp2, which is treated as equity for U.S. tax purposes but as debt for Country Y tax purposes. The hybrid security accrues (but does not pay) a current yield that is sufficient to soak up all or a substantial portion of Corp2's income, and is structured so that the accrual is taken into account on a current basis for Country Y tax purposes but not under Code Sec. 305. As a result Corp1 has taxable income (and pays tax) in Country Y but for U.S. tax purposes the associated income is in Corp2.

As in Example 2, U.S. Parent could claim a foreign tax credit under Code Sec. 902 when it receives a dividend from Corp1, but would not need to include the associated income from Corp2. Alternatively, if Corp1 were a disregarded entity for U.S. tax purposes, U.S. Parent could claim a foreign tax credit under Code Sec. 901 without regard to whether it receives any dividend from Corp1.

## B. Duplicate Benefits FTC Arbitrage Transactions

The second category of FTC-related arbitrage transactions that will be discussed in this paper involves transactions that permit the effective duplication of tax benefits in two countries, usually because the United States treats the U.S. participant as the owner of the entity that pays the foreign income (or withholding) tax and allows it a foreign tax credit while a foreign country treats the non-U.S. participant as owning all or a substantial portion of the entity for purposes of its tax law.

**Example 4. Duplicate Benefits FTC Arbitrage Through Repo**. USCo organizes Country X Newco (which is a disregarded entity for U.S. federal

income tax purposes) and invests $10x in Class A ordinary shares and $100x in Class B preference shares, which pay annual dividends at a five-percent rate. USCo sells the Class B shares to Country X Investor for $100x under a five-year repo agreement. USCo immediately prepays $75x of its forward purchase obligation under the repo, so that its remaining obligation to Investor will be fully satisfied through the dividend distributions on the Class B shares. Economically, therefore, Investor has made a five-year $25x interest-free loan to USCo. Newco invests its funds in a managed portfolio of high-credit securities, and pays Country X tax (at a 30-percent rate) on its profits. For Country X tax purposes, Investor is treated as an equity owner in Newco and is eligible for tax benefits associated with ownership of the Class B shares (for example, an imputation credit in respect of its share of Newco's taxes, that reduces its tax liability on other income). As a result, Investor is willing to compensate USCo through the interest-free loan. For U.S. federal income tax purposes, the transaction is treated as an interest-free loan by Investor to USCo that is secured by the Class B shares. USCo includes in income all of the earnings of Newco and claims a foreign tax credit for the Country X taxes paid by Newco.

Example 4 is a highly simplified presentation of the basic features of one variation of a duplicate benefits FTC arbitrage transaction. The basic features typically include (i) a joint investment by a U.S. and foreign participant in an entity that makes an investment (directly or indirectly) in debt instruments and pays foreign entity-level taxes on its profits (or a withholding tax), (ii) characterization of the structure for U.S. federal income tax purposes as an equity investment by the U.S. participant and a borrowing (by the entity or by the U.S. participant) from the foreign participant, (iii) characterization of the structure for foreign income tax purposes as an equity investment by the foreign participant and, depending upon the circumstances, either as a debt investment by the U.S. participant or as a proportionate equity investment, (iv) the U.S. participant claiming a foreign tax credit for the taxes paid by the entity, (v) the foreign participant claiming the benefits of ownership under foreign law (*e.g.,* under a consolidation or integration regime) or other foreign tax law benefits, and (vi) the foreign participant compensating the U.S. participant for the foreign tax benefits that it enjoys, by providing the U.S. participant with an enhanced yield on the investment, funding at an attractive financing rate or an outright payment for the foreign tax benefits.

As described in Part III below, a variety of techniques are employed to achieve the foregoing tax arbitrage results. Moreover, the transaction structures invariably are much more complicated than depicted in Example 4. Usually there are a number of entities involved on the part of each participant group, and the joint investment entity often has one or more subsidiary entities. Depending on the circumstances, the joint investment entity (or its subsidiaries) may borrow from, or issue equity or make loans to, affiliates of the U.S. and/or foreign participant. The joint investment entity (and similarly the various other entities) may be a corporation or a tax-transparent entity (either a partnership or a disregarded entity) for U.S. or foreign tax law purposes. Often there are swaps between the participants and/or between a participant and the joint investment entity (or their respective related entities), which serve various nontax objectives. Also, in some transactions the joint investment entity will invest primarily or exclusively in third-party securities while in other transactions the joint investment entity will invest primarily in debt instruments issued by (or receivables generated in the business of) one of the participants (or its affiliates), thereby providing direct funding to the business operations of that participant's group.

In many duplicate benefits FTC transactions ("self-sheltered" transactions), such as the transaction depicted in Example 4, the foreign tax credits generated in the transaction offset only the U.S. tax liability in respect of the income arising from that transaction, and do not offset U.S. tax on other foreign source income of the taxpayer. In other duplicate benefits FTC transactions (so-called hyped credit transactions), the foreign tax credits generated in the transaction exceed the U.S. tax liability on the income arising from the transaction, and those excess credits are available to offset U.S. tax liability on other foreign source income of the taxpayer that is in the same Code Sec. 904 limitation category (*i.e.,* "cross-crediting"). The hyped credit may be the result of various structural features, such as the non-U.S. participant providing a substantial amount of funding to the investment entity.[12] By way of illustration, under a variation of Example 4 that would produce hyped credits, USCo would not prepay any of its repurchase obligation and the Class B shares would represent, for U.S. federal income tax purposes, a $100x secured loan to USCo that bears a below-market interest rate.[13]

Leverage and the related interest deduction also play a role in other aspects of duplicate benefits FTC transactions, including in the application of the rules for allocating interest expense between foreign and U.S. sources for purposes of the Code Sec. 904 limitation,[14] the evaluation of the tax benefits from the transaction and the determination whether the transaction has economic substance.[15]

**Example 5. Foreign Withholding Tax Arbitrage Through a Partnership**. USCo invests $5x in Country A Partnership in exchange for all of its common equity, and Country B Investor invests $95x in Newco in exchange for a hybrid security that is treated as equity for Country A purposes but as debt for U.S. tax purposes. Partnership invests in preferred stock of a Country C corporation that pays dividends that are subject to a 25-percent withholding tax. USCo claims a foreign tax credit for such withholding tax (as well as a deduction for the interest expense on the hybrid security), while Investor claims a foreign tax credit in Country B for 95 percent of the withholding tax. The coupon on the hybrid security is lower than a market rate to reflect the tax benefit derived by Investor.[16]

In contrast to Example 4, in this case the foreign tax is a withholding tax rather than a net income tax, a foreign tax credit is being claimed in both countries (as opposed to a foreign tax credit in the United States and an imputation credit in the foreign country), and the transaction involves cross-crediting.

Many duplicate benefits FTC arbitrage transactions involve participants that are financial institutions (banks, securities firms, insurance companies, *etc.*). This is probably attributable to several factors, including the fact that (i) these financial institutions would in any event be making the sort of portfolio investments that typically are made in these transactions, as part of their ordinary business activity (and raising funds to do so), and thus these transactions simply enhance the after-tax returns of the participants on such investments (or provide funding at attractive rates); (ii) financial institutions are often in a better position to utilize the foreign tax credits that are generated in these transactions (even where the credits offset only tax on income from these transactions) due to the highly technical "basket" rules under the Code Sec. 904 limitation; and (iii) these transactions are extraordinarily complex as a financial, legal and tax matter, and most other companies are not set up to handle them.

However, these transactions are not limited to financial institutions or to special purpose entities that invest in affiliate loans or other debt securities. In addition to investing in special purpose joint investment entities as described in Example 4, U.S. multinational corporations may engage in duplicate benefits FTC arbitrage transactions in which the joint investment entity is a foreign operating subsidiary of the U.S. multinational.[17] For example, the U.S. multinational could raise inexpensive funding through a repo over the shares of its foreign subsidiary, where the repo is treated as a financing for U.S. tax purposes but as a purchase of the shares by the foreign participant for purposes of its home country's tax law.

**Example 6. Duplicate Benefits FTC Arbitrage Repo Financing for Foreign Subsidiary**. USCo is seeking $100x of debt financing to expand the business operations of its Country X subsidiary ("Sub"). Country X Bank offers to provide the financing at a below-market rate under the following terms: Sub issues $100x of preferred stock to USCo (in exchange for $100x) and USCo enters into a five-year repo agreement over the preferred stock with Bank. Bank receives dividends on the preferred stock (which are fixed at a rate to provide Bank with its agreed-upon return), and after five years resells the preferred stock to USCo at its original purchase price. Bank is willing to provide the financing at a below-market rate because the dividend income is not taxed in Country X because Country X grants Bank an imputation credit for Sub's Country X taxes in respect of the earnings to which the dividends relate. For U.S. federal income tax purposes, the transaction is treated as a loan by Bank to USCo that is secured by Sub's preferred stock. USCo includes in income the preferred stock dividends (grossed up for the related Country X taxes) and claims a foreign tax credit and an interest expense (equal to the dividend payments).

One issue considered in this paper is whether a distinction should be made between duplicate benefits FTC transactions that provide financing for operating subsidiaries of U.S. multinationals (Example 6) and those transactions in which the investment entity holds debt issued by unrelated persons (Example 4).

## C. Reverse FTC Arbitrage Transactions

In considering the policy issues raised by duplicate benefits FTC arbitrage transactions, it is worth comparing those transactions to similarly structured transactions in

which the joint investment entity is subject to net U.S. income tax. In such "reverse FTC arbitrage" transactions, the non-U.S. participant claims the U.S. tax as a foreign tax credit in its home country, while the U.S. participant receives its share of the investment entity's profits without additional U.S. tax, as a result of the 100-percent dividends received deduction or filing a consolidated return with the investment entity.[18]

**Example 7. "Reverse FTC Arbitrage" Transaction.** USCo organizes US Newco (treated as a corporation for U.S. federal income tax purposes) and invests $10x in Class A ordinary shares and $100x in Class B preference shares, which pay annual dividends at a below-market rate. USCo sells the Class B shares to Country X Investor for $100x under a five-year repo agreement. Newco invests its funds in a managed portfolio of high-credit securities, and pays U.S. income tax on its profits (either directly or as a member of the USCo consolidated group). For Country X tax purposes, Investor is treated as an equity owner in Newco and is eligible to claim a foreign tax credit for its share of Newco's taxes. As a result, Investor is willing to compensate USCo through the below-market dividend rate on the Class B shares. For U.S. federal income tax purposes, the transaction is treated as a loan by Investor to USCo that is secured by the Class B shares.

A key distinction between Example 7 and Example 4 is that in Example 7 the U.S. government collects tax whereas in Example 4 it does not (except to the extent if any that the effective rate of foreign tax is below the U.S. tax rate).[19] Whether, under what circumstances and why this should make a difference in considering whether anything, and if so what, should be done about duplicate benefits FTC arbitrage and reverse FTC arbitrage transactions is one of the topics discussed in this paper.

### D. U.S. Withholding Tax Claims Transactions

Another category of international arbitrage transactions that is worth comparing to duplicate benefits FTC arbitrage transactions is where an entity pays U.S. withholding tax that is claimed as a credit by both the U.S. participant and the foreign participant in their respective countries.

**Example 8. U.S. Withholding Tax Arbitrage**. USCo purchases shares in U.S. mutual fund Z for $100x. USCo enters into a repo over the shares with Country B Investor, and receives $90x. Investor is recorded as owner of the Z shares on the share register. The repo is treated as a financing for U.S. tax purposes but as a purchase for Country B tax purposes. Investor either (i) provides Z with a Form W-8BEN claiming beneficial ownership under the terms of the US-Country B income tax treaty and entitlement thereunder for a 15-percent withholding tax rate, or (ii) fails to provide any forms, which leads to backup withholding tax being paid. Investor claims a credit for the U.S. withholding tax in Country B, while USCo claims a refund (or credit) for such withholding tax on its U.S. tax return (as well as a deduction for the interest expense on the repo). The effective rate of return of Investor on the repo financing is lower than a market rate to reflect the tax benefit derived by Investor.

As in the case of Example 7, this example raises the question whether it should matter as a U.S. tax policy matter that a foreign participant is claiming benefits in respect of U.S. taxes as a result of a tax arbitrage structure where U.S. tax revenues have not been impaired.

## III. Common Structuring Techniques and Legal Considerations

### A. Common Structuring Techniques

The arbitrage transactions and structures that are described in Part II share a number of common features. An appreciation of these features may assist in formulating a view of how these transactions should be regarded as a policy matter and whether action, if any, to curb any of these transactions should involve modifying the U.S. federal income tax treatment of those features, or instead, other approaches.

The arbitrage transactions described in Part II (other than the FTC separation structures) employ one of several techniques to enable the U.S. participant to be treated as an equity owner of an interest in an entity for U.S. tax purposes but the non-U.S. participant to be treated as an equity owner of that interest (or otherwise to be eligible for benefits) for foreign tax purposes. These techniques are based on differences between the U.S. and foreign country tax rules regarding ownership or debt-equity characterization. Among the techniques that are employed are the following.

### *1. Repo Agreements*

In a basic repo agreement, *A* sells a (debt or equity) security of *C* to *B*, with an agreement to repurchase the security (at a specified date in the future or on demand) for an amount equal to the original sale price plus a time-value-of-money component. If the security pays a coupon, coupon distributions received by *B* during the term of the repo offset amounts otherwise payable by *A* at the time of repurchase.[20] Trillions of dollars worth of U.S. Treasury securities and other securities are financed on a daily basis through repo agreements.[21]

It is well-settled law that for U.S. federal income tax purposes, a repo is treated as a secured loan.[22] The basis for this conclusion is that, under U.S. tax principles, the determination of who is the tax owner of property depends primarily on who has the benefits and burdens of ownership of the property; legal title is relevant but not controlling. In the case of a repo (involving a sale and unconditional repurchase of property at a pre-agreed fixed price), the repurchase feature has the effect of protecting the buyer from any decline in value of the property and also denying the buyer any right to appreciation.

In some countries, a repo is treated for tax purposes as independent sale and re-sale transactions, so that *B* is treated as the owner of the security during the term of the repo. Thus a repo transaction where the underlying security is equity can serve as a device to enable both a U.S. participant and a foreign participant from such a country to be treated as the owner of the underlying equity for purposes of their respective tax rules. The entity whose equity is the subject of a repo may be a corporation, a partnership or a disregarded entity for U.S. federal income tax purposes.

In other countries, it may be necessary to modify the basic repo transaction in order to accommodate particular structuring requirements. For example, in transactions involving U.K. participants, market practice is to have the U.S. participant enter into a subscription obligation whereby it undertakes to either subscribe for shares of the issuer entity in a specified amount or ensure that another person so subscribe for such shares, and for the U.K. participant to then subscribe for such shares pursuant to an assignment of such subscription obligation. As part of the transaction, the U.K. participant would enter into a forward sale agreement in respect of those shares with the U.S. participant. The U.S. federal income tax analysis of the subscription agreement/forward sale agreement structure should not differ from that of the basic repo structure. Indeed, several of the repo authorities cited above involve newly issued securities that were purchased by the financing party directly from the issuer. Moreover, the payment of the subscription price by the U.K. participant to the issuer entity can be viewed as having been made on behalf of the U.S. participant because it relieves the U.S. participant of its subscription obligation.

### *2. "Broken" Repo Transactions*

In some transactions involving U.K. participants, the U.K. participant purchases or subscribes for shares of an issuer (also a U.K. tax resident entity, although generally not a U.K. incorporated entity) and sells them to an intermediary in a transaction that is denominated as a "sale-and-repurchase" transaction, but where the intermediary is free to sell the shares without restriction (in which case, it will return equivalent value property to the U.K. participant in the "repurchase" transaction). The intermediary then sells the shares without any restrictions to the U.S. participant. As a U.S. tax matter, the U.S. participant is the owner of the shares. For U.K. tax purposes, however, the U.K. participant derives benefits under the rules applicable to "manufactured dividends."[23]

### *3. Hybrid Securities*

Another prevalent technique to achieve arbitrage results is to have an entity issue a hybrid security. For example, the entity would issue to the foreign participant a security that is treated as debt for U.S. tax purposes but as equity for purposes of the foreign participant's tax law. Alternatively, the entity would issue to the U.S. participant a security that is treated as equity for U.S. tax purposes but as debt for purposes of the foreign participant's tax law. In either case, such a security is structured to take account of the voluminous body of U.S. tax law regarding the criteria for an instrument to qualify as debt or as equity,[24] and the differences in the debt-equity characterization rules between the U.S. and foreign tax rules. The entity issuing the hybrid security may be a corporation, a partnership or a disregarded entity for U.S. federal income tax purposes.

### *4. Hybrid and Reverse Hybrid Entities*

Yet another technique to achieve arbitrage results is to use a hybrid or reverse hybrid entity. The use of a reverse hybrid entity, of course, is integral to the FTC separation structure depicted in Example 2. And use of a hybrid entity in Examples 1 and 2 enables the U.S. taxpayer to claim a direct foreign tax credit under Code Sec. 901 instead of an indirect credit under Code Sec. 902.

In the context of duplicate benefits FTC arbitrage transactions, use of a hybrid entity can facilitate certain objectives. At the upper-tier investment entity level (as well as in the case of lower-tier investment entities), a hybrid may enable the U.S. taxpayer to claim a direct foreign tax credit under Code Sec. 901 instead of an indirect credit under Code Sec. 902. In the case of lower-tier investment entities, the use of a hybrid may facilitate compliance with technical rules regarding interest allocation and the Code Sec. 904 limitation.

Reverse hybrids are also employed in reverse FTC arbitrage transactions, where it is often important for purposes of the foreign participant's home country tax treatment that the entity itself incur liability for U.S. tax but it is also desirable for the foreign participant to derive its share of the income and credits of the entity as a partnership distribution.

The ability of taxpayers to establish hybrid and reverse hybrid entities is enhanced immeasurably by the CTB rules, which make entity classification for U.S. tax purposes largely elective.[25]

## B. The Maze of Legal Rules and Principles

Another common feature of many of the arbitrage transactions that are depicted in Part II is the need to navigate a maze of extraordinarily complex technical tax rules. In addition to the applicable U.S. tax rules, it is necessary to consider the tax rules of the relevant foreign country. An international tax arbitrage opportunity arises only if it is possible to structure a transaction that qualifies for the desired results under the rules of both countries, and if there is a sufficient number of potential participants with the necessary attributes and tax capacity. Other legal and regulatory considerations, as well as business and risk management issues, need to be addressed in a satisfactory manner in structuring any such transactions. Consequently, many of the transaction categories described in Part II are very difficult to implement, involve protracted negotiations, and result in extremely complicated transaction structures and documentation. Putting aside the FTC separation structures, to a great extent, these transactions generally present opportunities only for well-advised, sophisticated financial institutions and a certain limited class of multinationals that are willing to devote significant time, effort and resources to developing and implementing these transactions.[26]

As Part IV below illustrates, eligibility to claim a foreign tax credit is already subject to a number of formidable requirements. Insofar as they relate to duplicate benefits FTC arbitrage transactions, the most significant rules are the Code Sec. 904 limitation and the related rules under the Code Sec. 861 regulations for the allocation of interest expense.

Similarly, reverse FTC arbitrage transactions that are based on the dividends received deduction or consolidation must pass muster under a detailed set of domestic tax rules.

Apart from the technical rules that are implicated by each particular transaction or structure, the arbitrage transactions described in Part II must take account of general tax principles such as the economic substance, business purpose, substance over form, arm's length pricing and step transaction principles (and often must contend with general anti-abuse rules under the tax laws of the foreign country). Part VII.F below discusses the (limited) role that these general tax principles might play in policing such transactions. At this juncture I will simply observe that in my experience, these general U.S. tax principles—at least as understood and applied by the courts to date—do not preclude properly and prudently structured international arbitrage transactions; they simply raise the bar for transactions to pass muster and as a consequence presumably serve to weed out egregiously structured transactions.

Thus, most duplicate benefits FTC arbitrage transactions have a meaningful business purpose (apart from U.S. tax benefits) in that they provide the U.S. participant with a real economic benefit, in the form of low-cost financing, an enhanced return on an investment or an actual payment for the non-U.S. tax benefits that the foreign participant derives. These transactions also typically provide the U.S. participant a not-insignificant positive economic return (apart from tax benefits), although (i) depending on the circumstances and the manner in which the taxpayer's (directly traceable or generally allocable) interest expense is taken into account, this conclusion may be open to question[27]; and (ii) not all of these transactions would pass muster if a court were to treat foreign taxes as an expense rather than as a surrogate for U.S. tax under the rationale of the "enhanced economic profit" test of Notice 98-5 that was withdrawn by the IRS in 2004.[28]

# IV. The Foreign Tax Credit: Underlying Policies and Relevant Rules

The principal policy objective underlying the foreign tax credit is to prevent double taxation of a taxpayer's

foreign source income.[29] Because U.S. taxpayers are subject to federal income tax on their worldwide income, in the absence of a credit for foreign taxes, U.S. taxpayers would be "taxed twice on their foreign income—once by the foreign country where the income is earned, and again by the United States. The foreign tax credit generally allows U.S. taxpayers to reduce the U.S. tax on their foreign income by the foreign income taxes they pay on that income."[30]

Essentially, then, by allowing a credit rather than merely a deduction for foreign income tax expenses incurred by a U.S. taxpayer, the United States is ceding its taxing jurisdiction over the foreign income to the foreign tax authority. However, by granting a credit rather than an exclusion of foreign source income, the United States is reserving for itself the right of residual taxation of such income (*i.e.*, to the extent the U.S. tax rate exceeds the foreign tax rate).

Of course, the ceding of taxing jurisdiction must be exercised carefully lest it undermine the tax base. Under the Code, therefore, the foreign tax credit is subject to important conditions and limitations that are intended (i) to effectuate the overall policy objective as well as subsidiary considerations, and (ii) to circumscribe the availability of the credit to those circumstances in which it is appropriate as a policy matter for the United States to cede such taxing jurisdiction. These policies, conditions and limitations—which are organized below under five themes—may shed some light on whether and, if so, how any of the FTC arbitrage transactions described in Part II should be curbed.[31]

### *1. Definitional Requirements for a Creditable Tax*

The Code and regulations define and delimit the concept of creditable taxes so as to encompass only *bona fide* income (and certain withholding) taxes that are comparable to federal income (and withholding) taxes. Thus, very generally, in order to be creditable, a foreign tax must be substantially equivalent to an income tax in the U.S. sense,[32] or must qualify as an "in lieu of" tax (*e.g.*, a withholding tax similar to the sort imposed by the United States on gross income of foreign passive investors).[33] The foreign tax must be "a compulsory payment pursuant to the authority of a foreign country to levy taxes,"[34] and cannot be a payment in exchange for a specific economic benefit.[35] Nor can the tax be conditioned on the availability of a credit in another country (a so-called soak-up tax),[36] since this would allow a foreign government to "soak up" tax revenue at the expense of the U.S. fisc and without a corresponding disincentive on U.S. taxpayers to invest in the foreign country. A tax is not creditable "to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated or forgiven,"[37] or to the extent it is "used directly or indirectly, by the foreign country imposing the tax to provide a subsidy" to the taxpayer, another party to the transaction, or certain related parties.[38]

From time to time, the IRS has employed—or has considered employing—one or another of these definitional conditions for qualifying as a creditable tax as enforcement tools to deny a credit to a taxpayer that has structured a foreign tax credit-driven transaction. For example, in a situation involving the issuance of a hybrid security to a third party Country X investor by a Country X company ("DE") that was a disregarded entity of taxpayer for U.S. tax purposes, and the investment in a bank deposit by DE's subsidiary ("Sub"), which was resident for tax purposes in both Country X and the United States, the IRS held that taxpayer could not claim a foreign tax credit for taxes paid by Sub because it did not exhaust competent authority remedies under the U.S.-Country X treaty to determine the residence of Sub and therefore the foreign tax was not compulsory.[39] In that same situation, the IRS concluded (properly in my view) that the fact that the hybrid security enabled the third party Country X investor to claim an imputation credit did not mean that Country X granted an impermissible subsidy.[40] As discussed further in Parts VI.B.6 and VII.C.1 below, it is reasonable to consider with respect to duplicate benefits FTC arbitrage transactions, whether and under what circumstances a taxpayer's deliberate choice to invest in passive assets through a foreign entity and thereby to incur a foreign tax should be considered the incurrence of a noncompulsory tax.

### *2. The Role of Foreign Law*

The foreign tax credit area necessarily involves an interface between U.S. and foreign law. In general, the United States looks to foreign law to determine the relevant facts regarding the foreign tax (*e.g.*, the nature and amount of the tax, the tax base on which it is imposed, and who has legal liability therefor) but applies U.S. tax rules to determine the U.S. tax consequences of the factual tapestry that includes the relevant foreign tax facts. In the words of one commentator, "the cases are consistent in allowing 'factual' uses of foreign law and prohibiting 'interpretive' uses of foreign law."[41] Thus, in *Biddle*,[42] which involved the U.K. integrated tax regime, the Supreme Court stated that while it is appropriate to look to foreign law to ascertain the

relevant facts regarding liability for the foreign tax, the determination of which person has "paid" a foreign tax is made based on U.S. tax principles.[43] Similarly, the recent Claims Court decision in *Guardian Industries* looked to Luxembourg law to determine that the Luxembourg parent of a Luxembourg consolidated group had sole "legal liability"—rather than joint and several liability—for the tax of its subsidiaries within the meaning of Reg. §1.901-2(f)(3) (2005), discussed in Paragraph 3 below.[44]

The distinction between factual and interpretive uses of foreign law has some bearing on FTC-related arbitrage transactions, and it plays a prominent role in recently proposed regulations under Reg. §1.901-2(f), the technical taxpayer rule, discussed in Paragraph 3 below.[45] Parenthetically, the evidence, briefs and opinion in the *Guardian Industries* case are the latest illustration of the difficulties that taxpayers, the IRS and the courts often face in deciphering what the foreign law "facts" are and how to characterize such facts for U.S. federal income tax purposes. Apart from substantive considerations, these difficulties counsel in favor of minimizing to the extent possible the role that the factual aspects of foreign law play in determining the creditability of foreign taxes, a point that is borne out in Paragraph 3 and Part VII.C.3 below.

In a related vein, the Code and regulations contain rules for dealing with disparities between U.S. and foreign conceptions of income, as they relate both to timing of income and to the definition and scope of the tax base (and the category of income, or "basket," to which the tax relates).[46] In general, "these rules are designed to achieve the fairest result (*i.e.*, allowing a credit for foreign taxes) that is reasonably possible under the circumstances."[47]

### *3. The Technical Taxpayer Rule*

Under the so-called legal liability or "technical taxpayer" rule,[48] as promulgated in Reg. §1.901-2(f)(1) (as in effect prior to the general January 1, 2007, effective date of the proposed regulations described below), "[t]he person by whom tax is considered paid for purposes of Code Secs. 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (*e.g.*, a withholding agent) remits such tax."[49] Thus, under the pre-2007 version of Reg. §1.901-2(f), eligibility to claim a foreign tax credit turns on legal liability for the tax under foreign law; it is largely irrelevant whether the person who has legal liability actually bears the economic burden of the tax[50] or whether the tax base to which the tax relates is includible in income by such person.[51] "It is generally understood that the policy rationale behind this technical taxpayer rule is the desire to have a simple, straightforward rule that can be readily administered by taxpayers and the IRS and that avoids the difficult and often nebulous inquiries as to where the incidence of tax falls as an economic matter."[52]

Because of its mechanical nature and the absence of any explicit matching between the tax and the related income or economic incidence of tax, the technical taxpayer rule has been utilized both to block and to facilitate FTC-related arbitrage transactions. For example, perhaps presaging its re-interpretation of the technical taxpayer rule in the proposed regulations described below, the IRS recently relied on the technical taxpayer rule to deny a foreign tax credit to the holder of a participation interest in a note that was subject to withholding tax where foreign law treated the legal owner of the note and not the participant as the person that was legally liable for the withholding tax.[53]

More commonly, however, the technical taxpayer rule has enabled some taxpayers to claim a foreign tax credit in situations where they have not borne the tax as an economic matter and/or have not included the related income. For example, prior to the enactment of Code Secs. 901(k) and (l),[54] a taxpayer who purchased a bond or share of stock immediately before the relevant interest payment or dividend record date generally was eligible to claim a credit for the entire amount of the withholding tax on such interest or dividend payment even though as an economic matter it earned only a small portion of the income (corresponding to the short period prior to the interest or dividend payment during which it owned the bond or stock).[55] And the FTC separation structures described in Part II.A (Examples 1 through 3) above involving the separation of creditable taxes from the related income within a group of related entities (whether under certain consolidated tax regimes or reverse hybrid structures) rely on IRS pronouncements applying the technical taxpayer rule to the combined income of related taxpayers.[56]

On August 3, 2006, the Treasury and the IRS proposed new regulations under the technical taxpayer rule of Reg. §1.901-2(f) that would be effective for taxable years beginning on or after January 1, 2007.[57] The proposed regulations should effectively prevent the separation of foreign tax credits from the related income in the consolidated tax regime and reverse hybrid situations described in Part II.A above. The proposed regulations would amend and clarify the general "legal liability" rule by providing that, "In

general, foreign law is considered to impose legal liability for tax on income on the person who is required to take the income into account for foreign income tax purposes."[58] The proposed regulations address the situation in which foreign tax is imposed on the combined income of two or more persons, such as a corporation and its subsidiaries (*e.g.,* the *Guardian Industries* situation depicted in Part II.A, Example 1, above), by (i) allocating the tax on a *pro rata* basis, in proportion to each person's portion of the combined income as determined under foreign law[59]; (ii) adopting a broad definition of combined income[60]; and (iii) dropping the current regulation's condition[61] that the persons be jointly and severally liable before the "combined income" allocation rule can apply. The proposed regulations also provide that, for purposes of applying the "combined income" allocation rule to a reverse hybrid entity, the tax that is imposed on an owner's share must be allocated between the owner and the reverse hybrid on a *pro rata* basis in proportion to the tax base that is treated as the income of each (so that if the owner has no income on which tax is imposed by the foreign country other than from the reverse hybrid, the entire amount of foreign tax is considered paid by the reverse hybrid).[62]

The proposed regulations contain two examples illustrating the new general rule that "foreign law is considered to impose legal liability for tax on income on the person who is required to take the income into account for foreign income tax purposes." Example 2[63] modifies a corresponding example in the current regulations,[64] involving a withholding tax on interest in respect of a loan that is made through a nominee or agency arrangement, to add as a factual predicate that the foreign country imposing the tax recognizes the nominee or agency arrangement and thus considers the taxpayer to be the beneficial owner of the interest income. The clear implication is that were the nominee to be treated as the owner of the income under foreign law, the taxpayer would not be eligible for a foreign tax credit, and indeed the preamble requests comments on this treatment.[65] Similarly, Example 3,[66] which involves a repo of a bond issued by a non-U.S. issuer, concludes that the taxpayer, which repoed out the bond and is treated as beneficial owner of the bond under U.S. tax principles, is not eligible to claim a credit for the foreign withholding tax because the foreign country treats the party that repoed in the bond (and holds legal title thereto) as the owner for tax purposes. These examples appear to depart from current commercial practice and existing law, as understood in a series of cases involving Brazilian and U.K. withholding taxes as well as other authorities.[67]

The result in the foregoing examples—denial of a foreign tax credit to a beneficial owner that must include the income for U.S. tax purposes—appears highly questionable as a tax policy and administration matter. This new requirement will impose an unnecessary and unwelcome burden upon taxpayers and the IRS in many common commercial situations to determine whether the tax law of a particular country treats the U.S. taxpayer as the taxpayer under a particular nominee, agency or repo arrangement. Indeed, given the prevailing practice of the capital markets to hold trillions of dollars worth of stock as well as debt securities through nominee arrangements,[68] it will be necessary to investigate the treatment of each particular arrangement under the foreign law of virtually every country that imposes a tax that is potentially eligible for a direct or indirect foreign tax credit. One can imagine that the factual and legal analysis will not always be easy, and indeed may be open to dispute, thereby undermining the administrative simplicity that is the objective of the technical taxpayer rule. Moreover, while fortuitously Code Secs. 901(k) and (l)[69] will prevent the nominee, agent or repo counterparty from claiming the foreign tax credit in many cases, there will likely be situations that are outside the ambit of those provisions, so that the proposed regulations may spawn a new genre of tax-driven transactions in which foreign tax credits are separated from the related income.[70]

The proposed regulations may be faulted for their failure to adhere to the distinction drawn in *Biddle* between (i) looking to foreign law to ascertain the relevant facts regarding legal liability for the foreign tax, and (ii) determining which person has "paid" the foreign tax in accordance with U.S. tax principles.[71] Consistent with *Biddle* and the Brazilian and U.K. withholding tax cases and other authorities, the proposed regulations should have provided that (i) the relevant facts of which person is required to take the income into account and therefore has legal liability, as well as the amount of foreign tax that is related to that income, are to be determined under foreign law, but (ii) the resultant matched amounts of income and tax (as determined under foreign law) are attributed to a particular taxpayer (or taxpayers) for purposes of Code Sec. 901 applying U.S. tax principles. Under this approach (and contrary to the implication of Example 2 and the conclusion of Example 3 of the

proposed regulations), the beneficial owner under U.S. tax principles, rather than its nominee, agent or repo counterparty, would always be treated as the U.S. taxpayer that "paid" the foreign withholding tax, regardless of whether foreign law respects the nominee agency, or repo financing relationship.

Lurking beneath the foregoing discussion of the technical taxpayer rule and the proposed regulations are the questions (i) as a policy matter, to what extent should the mechanical rule—which ostensibly is administratively straightforward to apply—that treats foreign taxes as "paid" by the person on whom foreign law imposes legal liability (or whom foreign law requires to include the related income) be retained, and to what extent should this rule be replaced by a rule that directly matches the foreign tax and the related income and attributes both to the person that is required to include the income for U.S. tax purposes, and (ii) even if it might be desirable as a policy matter to depart from the technical taxpayer rule, do the Treasury and the IRS have the authority to do so given its long history and the view of some that the *Biddle* case mandates this rule. The first question provides a subtext for much of this paper's discussion of the FTC separation structures, and is addressed further below.[72] As to the second question, I believe that the Treasury and the IRS have the authority to depart from the technical taxpayer rule to the extent necessary to address the situations described in Part II, for the reasons set forth in the NYSBA Section 1.901-2(f)(3) Report,[73] and I will not repeat that analysis here.

### *4. Cross-Crediting, the Code Sec. 904 Limitation and the Interest Allocation Rules*

In order to ensure that the foreign tax credit alleviates double taxation of foreign source income but does not allow a taxpayer to utilize the credit to offset U.S. tax on U.S. source income, Code Sec. 904 limits the credit to the amount of U.S. federal income tax that would otherwise be owed in respect of such foreign source income. Over the years, the limitation has oscillated between being formulated as an overall limitation based on the taxpayer's aggregate foreign source income, a separate per-country limitation, or (as is now the case) a separate limitation based on categories (or "baskets") of income.

When in 1986 Congress shifted from an overall limitation based on the taxpayer's aggregate foreign source income and adopted nine separate baskets for applying the Code Sec. 904 limitation,[74] it indicated that it was seeking to strike a balance between various competing considerations, including (i) allowing some degree of cross-crediting or "averaging" of taxes, whereby taxpayers can credit high foreign taxes paid on one stream of income against the residual U.S. tax that would otherwise be due on other, lightly taxed foreign income, which Congress viewed as consistent with the integrated nature of U.S. multinational operations abroad, while (ii) discouraging taxpayers with excess foreign tax credits from placing new investments—in particular, mobile passive investments that will be subject to lower foreign income tax—abroad rather than in the United States in order to benefit from their excess foreign tax credit position and thereby reduce or eliminate U.S. tax on such investment income. In addition, Congress expressed a concern that the lack of separate baskets, combined with other features of the 1986 Act, could have tilted the relative balance of the tax rules in favor of foreign investment, and also thought that the broad cross-crediting allowed under prior law had the unintended effect of reducing the pressure on foreign countries to reduce their tax rates.[75] More recently, the 2004 Act reduced the foreign tax credit baskets to two,[76] effective for taxable years beginning after 2006, in order to "undo much of the complexity created by the Tax Reform Act of 1986[,] ... reduce double taxation, make U.S. businesses more competitive, and create jobs in the United States."[77]

Clearly, the Code Sec. 904 limitation embodies the critical tax policy considerations of preventing double taxation of foreign source income but not permitting improper sheltering of U.S. or other foreign source income from U.S. tax, and thereby encouraging the economic and tax policies described in Part V.A.1 below by not unduly favoring or discriminating against foreign investment activity. Congress' periodic tinkering with the Code Sec. 904 limitation evidences the difficulty in striking an appropriate balance between the competing policy considerations, as well as the highly charged political and economic stakes of this debate. However, beyond broad palliative policy pronouncements, it is questionable what operative implications regarding FTC-related arbitrage transactions can be derived from the history and details of the Code Sec. 904 limitation. Indeed, given the extraordinary degree of detail and complexity of these rules (and the related sourcing rules described below) and the level of Congressional and regulatory attention that they have received, one might reasonably deduce that whatever cross-crediting of foreign tax

credits against other foreign source income might result under those rules is consistent with current law and policy, and should not be further curtailed.[78]

The Code Sec. 904 limitation works together with an intricate set of rules for allocating income and deductions (including interest expense) between U.S. and foreign sources. Because these sourcing rules determine the U.S. or foreign source of items of income and expense for purposes of the Code Sec. 904 limitation, they affect the amount of foreign taxes that may be creditable by a taxpayer. A number of these sourcing rules—including, in particular, the source rules for research and development expense and for sales of inventory—appear to reflect significant national economic and political decisions to provide tax incentives to U.S. multinationals, and can be said to operate at cross-purposes with an objective and neutral application of the tax policies underlying the foreign tax credit because they enhance the amount of creditable taxes under the Code Sec. 904 limitation (for example, by allocating a disproportionately large amount of research and development expense to U.S. sources and a disproportionately large amount of inventory sales income to foreign sources).[79] By contrast, at least until the 2004 Act changes to the interest allocation rules become effective for taxable years beginning January 1, 2009, the interest allocation rules artificially reduce the amount of creditable taxes under the Code Sec. 904 limitation because they allocate a disproportionately large amount of interest expense to foreign sources.[80]

The interest allocation rules can be an important consideration in structuring duplicate benefits FTC arbitrage transactions. In general, the interest allocation rules allocate the overall interest expense of an "expanded" affiliated group (including but not limited to any interest expense arising in the particular FTC arbitrage transaction, *e.g.,* as a result of the existence of a repo for U.S. tax purposes) between U.S. and foreign sources based on the relative tax bases or fair market values of the assets of the group that are held for the production of U.S. and foreign source income, respectively.[81] Consequently, depending on the circumstances of a particular taxpayer, even if the nominal foreign tax rate on the income from the FTC arbitrage transaction is below the U.S. federal income tax rate, the effective foreign tax rate can be higher than the federal rate as a result of the allocation of a portion of the group's overall interest expense against income from the FTC arbitrage transaction. In that event, the taxpayer may not be able fully to utilize the foreign tax credits generated in the transaction unless it is in an excess limitation position and is able to utilize the credit to offset other foreign source income in the same Code Sec. 904 "basket."

Sometimes financial institutions—which are highly leveraged and therefore are more susceptible to being subject to a Code Sec. 904 limitation as a result of the interest allocation rules—will organize a subsidiary (a "deconsolidated subsidiary") that is not part of the expanded affiliated group (*i.e.,* because at least 20 percent of the voting power and value of the stock of the subsidiary is held by persons whose ownership is not attributed to the U.S. parent) to participate in FTC arbitrage transactions and other investments.

Where a dual benefits FTC arbitrage transaction produces foreign source income that is putatively in the passive basket (as opposed to the financial services or general basket), a complicated set of rules must be applied to differentiate between low-taxed passive income, which remains in the passive basket, and high-taxed passive income, which is recharacterized as general basket income. The high-tax test is applied to discrete items using a number of criteria (including, for example, treating items earned by separate disregarded entities that are separate qualified business units ("QBUs") as discrete items). Associated foreign tax credits are also divided between the passive and general basket income for purposes of applying the high-tax test.[82]

Treaty provisions can affect the application of the sourcing and foreign tax credit rules to a particular transaction, for example by recharacterizing U.S. source income that is taxed by the treaty country as foreign source income for U.S. foreign tax credit purposes.[83]

In sum, the Code Sec. 904 limitation and the related interest allocation rules introduce significant complications in structuring duplicate benefits FTC arbitrage transactions, but generally do not present an insurmountable barrier to such transactions.

### *5. Recent Anti-Abuse Measures: Code Sec. 901(k) and (l) and the Partnership FTC Allocation Regulation*

In recent years, Congress and the IRS have adopted several rules to curb tax-driven transactions involving foreign tax credits. The approaches that were taken by these rules differ from one another, and are potentially informative regarding possible responses to other FTC-related arbitrage transactions.

As noted above, prior to enactment of Code Secs. 901(k) and (l), a taxpayer who purchased a bond

or share of stock immediately before the relevant interest payment or dividend record date generally was eligible to claim a credit for the entire amount of the withholding tax on such interest or dividend payment even though as an economic matter it earned only a small portion of the income (corresponding to the short period prior to the interest or dividend payment during which it owned the bond or stock).[84] In response, Code Secs. 901(k) and (l) generally deny a credit for withholding taxes unless the taxpayer satisfies a minimum 16-day holding period and is not "under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property."[85]

Congress' response to the splitting between income and withholding tax in the context of a short holding period in a share of stock or a bond was to adopt a targeted minimum holding period/short sale rule, patterned after the minimum holding period/no short sale requirements for the dividends received deduction, rather than revising the technical taxpayer rule so as to more closely align the allocation of the income and the related tax.

By contrast, the Treasury and the IRS responded to transactions involving partnerships specially allocating foreign tax credits by promulgating Reg. §1.704-1(b)(4)(viii),[86] which effectively requires a partnership to allocate creditable foreign tax expense ("CFTE") in proportion to the partners' distributive shares of income to which the CFTE relates. This matching approach makes sense in the partnership context, where Code Sec. 704(b) and the regulations thereunder require that allocations of items (including creditable foreign income taxes) that do not have substantial economic effect must be made in accordance with the partners' interests in the partnership.[87]

The partnership FTC allocation regulation under Code Sec. 704 contains detailed rules (consistent with the principles described in Paragraph 2 above and the purpose of the regulation) for applying U.S. and foreign tax law principles. It also provides generally sensible guidance for matching the CFTEs with the related income base, including special rules for preferred returns, guaranteed payments, timing and base differences between foreign and U.S. law, and items that are disregarded for U.S. tax purposes.[88] Part VII.H below considers the extent to which the approach of the partnership FTC allocation regulation might be relevant in considering possible approaches to duplicate benefits FTC arbitrage transactions.

## V. Overview of Policy Considerations: A Framework for Analyzing International Tax Arbitrage Transactions

This Part V examines some of the broad policy issues raised by international tax arbitrage transactions, and in particular, proposes an approach for addressing the ultimate question of whether there is anything wrong with these transactions, and if there is something wrong, what exactly is the problem. It summarizes the various views on this question that have been advanced by commentators and reviews the principal arguments presented on the various sides of the question. Drawing upon an approach suggested by some commentators, this Part then recommends a general framework for evaluating international tax arbitrage transactions. This framework would evaluate each type of international tax arbitrage transaction based on relevant tax policies and other factors, to determine whether that type of transaction should be curbed. This Part concludes with a nonexclusive list of such policies and other factors that appear relevant in addressing the categories of transactions described in Part II.

Very generally, international tax arbitrage arises when a taxpayer or taxpayers rely on differences between the tax rules of two countries to structure a transaction, entity or arrangement in a manner that produces overall tax benefits that are greater than what would arise if the transaction, entity or arrangement had been subject only to the tax rules of a single country.[89] It is critical to note that the types of international tax arbitrage discussed herein do not involve an incorrect or technically improper application of the tax laws of any country,[90] but rather situations in which the transaction, entity or arrangement complies with the tax rules of each country. Nonetheless, because the two countries apply different rules to the transaction, entity or arrangement, the result is a greater overall tax benefit to the parties (viewed from a global tax perspective) than if the transaction, entity or arrangement had been subject only to the tax rules of a single country.

Consequently, it has been cogently contended that there is nothing wrong with such international arbitrage transactions: After all, the taxpayer or taxpayers have scrupulously followed the tax law dictates in each country.[91] Thus, the argument goes, it should be of no interest or concern to Country A that a taxpayer in Country B obtains a tax benefit under Country B's tax law as well (whether or not the taxpayer in Country B is the same

person as the taxpayer in Country A, an affiliate thereof, or an unrelated person). Indeed, the proponents of this position would argue, Country A should be pleased to the extent that its taxpayer's economic returns have been enhanced by reason of its ability to enjoy, directly or indirectly (for example, through the pricing of the terms of a transaction with its counterparty, a Country B taxpayer) Country B's tax benefits.

A common example of this double benefit outside the foreign tax credit area is the double-dip lease transaction, where the U.S. lessor-owner of property in a leveraged lease transaction structures the financing of its investment through a cross-border sale and leaseback (or sale and repurchase) agreement with, say, a French counterparty, that is treated as a debt financing for U.S federal income tax purposes but as a transfer of ownership of the leased asset to the French counterparty for French tax purposes. Both parties are thus able to deduct the depreciation expense related to the asset in their respective countries. The fact that the French party is eligible for a benefit under French law has no direct negative effect on U.S. tax revenue. Moreover, because the French party is eligible for this tax benefit, the U.S. party typically will enjoy a reduced financing cost compared to a conventional U.S. borrowing (which will increase its U.S. tax payments).

An opposing view is that international tax arbitrage is problematic because it produces overall tax benefits that were not intended by either country. Under this view, depending on the circumstances, an international tax arbitrage transaction may undercut the policy behind a particular tax benefit afforded by a country and therefore the taxpayer should properly be denied that tax benefit.[92] More generally, advocates of this position have argued that there is a basic principle of international taxation (the "single tax principle"), under which "income from cross-border transactions should be subject to tax once (that is, not more but also not less than once)," with the right to tax active business income generally being allocated by general consensus primarily to the source jurisdiction, and the right to tax passive investment income being allocated primarily to the residence jurisdiction of the recipient taxpayer.[93] International tax arbitrage is often inconsistent with the single tax principle because it results in economic income being subject to less than a full single incidence of tax on a global basis. For example, prior to the enactment of the dual consolidated loss (DCL) disallowance rules,[94] a multinational group could utilize a dual residence corporation that is leveraged and is a member of both a U.S. and a foreign consolidated tax group of the multinational group to claim two deductions for the same interest expense and thereby to reduce the tax liability of both the U.S. and the foreign consolidated tax groups.

While there is some merit in each of these opposing positions, it would appear that neither approach provides a satisfactory framework for considering the gamut of situations and policy issues presented by international tax arbitrage.

The view that there is nothing wrong so long as the transaction, entity or arrangement complies with the tax rules of each country may indeed be the appropriate conclusion in a given situation, but it would appear that that conclusion can be reached only after a more encompassing and penetrating analysis of the various factors and policy considerations that are implicated by the particular situation. A list of various considerations that appear to be relevant in evaluating the situations described in Part II is set forth below.

On the other hand, as others have already noted, outside the treaty context, it is difficult to perceive a recognized single tax principle, and even in the treaty context, this principle is given scant operative effect.[95]

Historically, "since Adam Smith, it has been commonplace to say that a tax system should be fair, economically efficient, and reasonably easy to administer and comply with."[96] With these three overriding principles serving as general guidelines, and following in the footsteps of other commentators,[97] this article takes the position that each type of international tax arbitrage situation needs to be examined, based on relevant tax policies and other factors, to determine whether that type of transaction is problematic and therefore should be curbed. The analysis needs to be flexible, taking into account the specific factual context and weighing the applicable considerations, including the efficacy of possible solutions.

While the relevant considerations and the weight to be accorded to each will vary depending on the specific context, the following policy considerations appear to be generally relevant to analyzing the situations described in Part II.

### *1. The Macro-Economic Impact: Efficiency vs. Competitive Advantages and Incentives; Capital Export Neutrality and Capital Import Neutrality*

An important policy consideration in evaluating any tax issue is its effect on economic efficiency and the extent to which the particular tax rule distorts taxpayer behavior. Although questions of economic

efficiency can be analyzed in a variety of ways, the basic idea is that there is an efficient equilibrium level for investment in a given country or industry, and to the extent possible, taxation should minimize distortion of this equilibrium.[98]

Traditionally, efficiency concerns in the international tax context have often been analyzed through the dual concepts of capital export neutrality and capital import neutrality, although some economists and academics now aver that these concepts do not completely reflect the breadth of relevant economic considerations.[99]

In general, capital export neutrality seeks to prevent tax considerations from distorting the decision whether to invest domestically or abroad by adopting tax rules that treat domestic and foreign investments in an equivalent manner.[100] The foreign tax credit is a product of capital export neutrality, and an important by-product of that principle is that it does not make a difference as a matter of international economic efficiency whether the host (*i.e.,* source) country or the home (*i.e.,* residence) country collects the tax.[101] Whether this indifference as to whether the source or residence country collects the tax also exists (or should exist) as a matter of U.S. tax policy has considerable relevance to an analysis of FTC arbitrage transactions, as discussed in Part VI.B.6 below.

Capital import neutrality generally seeks to promote international competitiveness of home country multinationals and the efficient allocation of savings by requiring that within a given jurisdiction, domestic and foreign investors should face the same after tax rate of return on their investment.[102] In contrast to a pure capital export neutrality approach, which generally is considered to favor taxation only by the residence country, a pure capital import neutrality approach is generally considered to favor taxation only by the source country.[103] U.S. international tax policy reflects capital import neutrality in the deferral of active business income earned by foreign subsidiaries, but it does not adopt the pure capital import neutrality approach of exempting foreign source income altogether from U.S. taxation.

Because capital export neutrality and capital import neutrality cannot both be satisfied unless tax rates are uniform in all (relevant) countries, governments necessarily make international tax policy decisions that may favor one policy objective over the other.[104] It is generally believed that the international tax policy of the United States, at least over the past 45 years, has tended to favor capital export neutrality, although (as noted) important capital import neutrality concepts are also embodied in the U.S. tax rules, so that it is probably more accurate to describe U.S. international tax policy as reflecting a compromise between these two principles (as well as other considerations).[105]

Commentators generally believe that international tax arbitrage militates against economic (and international tax) efficiency, because it introduces tax benefits—often unintended by the relevant governments—into the equation whether to engage in a particular activity or transaction. For example, as noted in the double-dip leasing situation described above, while the U.S. government may have intended accelerated depreciation to serve as an incentive for capital investment, when depreciation is allowed in two countries for the same asset, it may result in over-investment in that asset.[106] However, virtually every tax benefit—indeed, virtually every decision that is made in crafting a tax system—can be said to influence taxpayer behavior in some way and thereby to cause a deviation from a pure model based on economic efficiency.[107]

Moreover, the point has been made that when evaluating economic efficiency in the context of international tax arbitrage, it is important to recognize that while eliminating a particular tax arbitrage structure may enhance global economic efficiency, it may disadvantage an individual country.[108] Thus, a country may not view a particular international tax arbitrage structure as problematic if that structure does not impair its own tax revenues but, rather, only those of another country and, indeed, enhances the economic returns of its taxpayer-participant in the structure (thereby potentially increasing tax revenues) and/or attracts foreign capital. For this reason, it is difficult to identify a material U.S. tax concern with the U.S. withholding tax claims transactions described in Part II.D, Example 8. In other words, national economic well-being (including the competitiveness of its multinational enterprises) may point in a different direction from international global efficiency, at least in the short-to-mid-term horizon for which many tax rules and other political decisions are made. Therefore, it should not be surprising if in such a situation the lofty principle of capital export neutrality gives way to more practical, political or economic considerations.

More generally, our national economic and tax policies often intentionally depart from the capital export neutrality principle and the maximization of international economic efficiency in order to advance other national interests, such as attracting foreign capital, encouraging exports, enabling U.S. multinationals to

better compete internationally, providing economic incentives or protection to particular industries, *etc.,* whether such national interests are framed by reference to the concept of capital import neutrality or other (explicit or implicit) national interests.[109]

In sum, while an academic purist might well espouse a rule that would eradicate all international tax arbitrage structures on the grounds that they violate the principle of international tax efficiency (perhaps coupled with the equity and abuse concerns discussed below), an approach that is more in line with the way tax policy is in fact implemented would factor international tax efficiency into an overall balancing of the various relevant considerations, including other economic and political objectives. Indeed, because the concepts of economic efficiency and capital export neutrality are considerably more abstract than various other considerations and have a less immediate impact on the economic well-being of a country and affected taxpayers than such other considerations, it appears that these concepts should (and often probably do) operate more as aspirational, high-level guiding principles than as operative and determinative guidelines.

### *2. Equity Concerns: Fair Allocation of Tax Burden and the Perception of Abuse*

A second set of general tax policy considerations that generally are considered relevant to international tax arbitrage relates to equity and fairness.[110] Among the pertinent questions are: If and to the extent that international tax arbitrage substantially reduces the tax burden of a discrete group of taxpayers (typically, financial institutions and other sophisticated multinational corporations that have the wherewithal to engage in such complex transactions), is that fair?[111] Is it relevant whether other taxpayers also have opportunities to participate in international (or other) tax arbitrage transactions? Does it make a difference, in evaluating the fairness of the result, whether the particular international tax arbitrage transaction involves scrupulous compliance with existing U.S. tax rules—which, upon careful reflection, seem to be rational and coherent—and the interplay between those rules and foreign tax rules that apply to a non-U.S. party? Should it make a difference, in evaluating the fairness of the result, whether the non-U.S. party is related or unrelated to the U.S. taxpayer? In the case of FTC arbitrage transactions, is it an adequate response to the fairness concern that the capital export neutrality principle—and arguably the foreign tax credit—embody a policy indifference as to whether domestic or foreign taxes are paid?[112] Thus, is the fairness issue mooted if a particular FTC arbitrage transaction does not reduce the taxpayer's overall (worldwide) tax burden but, instead, simply reduces its financing costs (or increases its investment yield), because a non-U.S. party to the transaction is willing to pay the U.S. taxpayer for the non-U.S. tax benefits that the structure afforded it? Finally, in evaluating the efficacy of a potential governmental response to a particular international arbitrage transaction, would it be a breach of the fairness principle (which generally seeks to have similarly situated taxpayers subject to similar tax treatment) to adopt a solution that, for example, (i) is straightforward but broad in scope and thereby covers benign and/or salutary transactions as well as targeted transactions or, alternatively, (ii) is highly technical and thereby increases the compliance burden of many taxpayers but enables more sophisticated taxpayers to develop structures that circumvent the government's solution?

As the foregoing questions suggest and the discussion in Parts VI.B.7 and 10 below illustrates, while fairness is commonly mentioned as a key consideration, its implications for a particular international tax arbitrage situation may prove elusive.

A related, important consideration is the public perception of unfairness and abuse that international tax arbitrage almost invariably engenders. Regardless of whether particular international arbitrage structures, when properly viewed, raise fairness concerns, there is nonetheless a significant problem if the public perceives international tax arbitrage as an abusive or unfair practice. As in the case of tax shelter activities, such a perception may cause public support for, confidence in, and willingness to comply voluntarily and fully with the self-reporting and self-assessment features of, the tax system to wane. The corrosive effect of such a perception cannot be underestimated, even where it is based on inaccurate information or misunderstanding of the facts, which often will be the case given the complexity of the structures and the factual and legal analyses involved.[113]

### *3. Impact on Tax Base and Tax Revenues*

An obvious and important consideration is the effect of international tax arbitrage (and of particular types of such transactions) on tax revenues. This concern is naturally interconnected with the fairness concern.[114] As previously noted, however, some types of transactions reduce U.S. tax revenues while others do not, but instead simply compensate a U.S. taxpayer (through an

enhanced yield on its investment or reduced financing cost) for affording non-U.S. tax benefits to a foreign counterparty. In addition, whether an international tax arbitrage transaction is considered to reduce U.S. tax revenues depends on what is the proper "baseline" for evaluating the transaction—*i.e.,* is it appropriate to assume that in the absence of the tax benefit, the taxpayer would have made a fully taxable U.S. investment, or should the assumption be that the taxpayer would have made the foreign investment but without receiving the benefit of the enhanced yield or reduced financing cost, or alternatively that the taxpayer would have made a tax-advantaged U.S. (or foreign) investment?

In any event, if and to the extent that international tax arbitrage transactions that reduce the amount of U.S. tax payable by the participants are viewed as significant phenomena, the implications of the revenue loss to the fisc would need to be considered. The loss of the tax revenues would justify combating at least those international tax arbitrage transactions that materially reduce U.S. tax revenues and do not advance other beneficial policies.

### *4. The Factual Context*

The factual context in which a particular international arbitrage transaction (or type of transaction) presents itself can implicate a variety of potentially significant considerations that may have a bearing on whether the transaction (or type) should be considered benign or troublesome as a tax policy matter. This discussion considers three categories of factual contexts—(i) whether the transaction involves an inbound investment in the United States or an outbound investment abroad, (ii) whether the transaction involves a direct business investment or a passive portfolio investment, and (iii) whether the person that is benefiting from the non-U.S. tax treatment of the transaction is related or unrelated to the U.S. taxpayer. These categories can intersect with each other in different ways that can either reinforce a particular policy direction or operate at cross-purposes.

**Inbound vs. outbound.** The direction of the investment—inbound vs. outbound—can affect which U.S. tax rules are implicated as well as whether the arbitrage transaction undermines important U.S. tax policies. For example, it has been perceptively noted[115] that perhaps one reason why the United States has not moved aggressively against traditionally structured double-dip leveraged lease transactions is that those transactions generally involve a U.S. owner-lessor leasing a U.S. asset (an activity which the U.S. domestic leveraged leasing rules are intended to promote so as to encourage capital investment in such assets) and enhancing its return by "selling" the non-U.S. tax benefits of ownership to a foreign participant. Outbound double-dip leases involving non-U.S. assets and/or non-U.S. lessees (which understandably the United States does not have an interest in promoting through tax incentives) have become largely uneconomic as a result of the enactment in 1984 of much less favorable depreciation rules for such assets,[116] and to the extent taxpayers have attempted to circumvent the impact of those rules through LILO ("lease in-lease out") and SILO ("sale in-lease out") transactions, the IRS (and eventually Congress) have responded vigorously.[117]

Similarly, in the context of FTC arbitrage transactions, as discussed in Part VI.B.9 below, one might reasonably draw a distinction between a "reverse FTC arbitrage" transaction, in which the investment is in U.S. assets that are subject to net U.S. income tax (while affording the non-U.S. participant a foreign tax credit or some other tax benefit),[118] and a duplicate benefits FTC arbitrage transaction, in which the investment generally is in foreign assets (so that the U.S. taxpayer is claiming a foreign tax credit while the non-U.S. participant is also claiming a foreign tax credit or some other tax benefit).[119] In the former case, the United States may be perfectly happy as a tax policy matter to permit its taxpayers to reap the benefits of the arbitrage transaction at the expense of the non-U.S. fisc. The latter case, on the other hand, raises a variety of additional tax policy issues, as discussed in Part VI.B below, although it may fairly be asked whether the appropriate baseline is a foreign investment that in any event would not have resulted in additional U.S. tax revenues.[120]

**Direct business investment vs. passive portfolio investment**. The evaluation of an international tax arbitrage situation may also be affected by whether it involves a direct business investment or a passive portfolio investment. As indicated above, the practice of the United States and most other developed countries is to grant the source country the primary right to tax direct business investments (assuming a sufficient nexus threshold has been satisfied) and to grant the residence country the primary right to tax passive portfolio investments. Additionally, in the case of direct business investments, the source country typically seeks to promote the investment because it stimulates economic activity and benefits (*e.g.,* employment, sales and asset production and use), while the residence country also typically seeks to encourage the investment to strengthen the competitiveness

and profitability of its multinational enterprises.[121] In the case of passive portfolio investments, the source country is motivated to generally exempt the investment from tax in order to be able to attract capital in a competitive international investment environment, while the residence country's principal interest is to ensure that it can identify and properly tax the offshore passive investment income.[122]

In general, one might expect there to be a lower tolerance threshold for international tax arbitrage transactions involving passive portfolio investments than those involving direct business investments, at least in the absence of any countervailing policy considerations.

Thus, Congress' insistence that the IRS back away from its efforts in Notice 98-11[123] to prevent U.S. based multinationals to utilize hybrid entities and securities to reduce the foreign tax burdens of their subsidiaries that are controlled foreign corporations can be explained, at least in part, as influenced by the fact that it did not perceive it to be abusive for a U.S.-based multinational to benefit from international tax arbitrage techniques that reduced their foreign tax burdens with respect to their direct (outbound) business investments and thereby improved their competitiveness.[124]

The distinction between direct (outbound) investment and passive investment may provide a rationale for exempting duplicate benefits FTC arbitrage transactions that provide cheap financing for foreign operating subsidiaries of U.S. multinationals (Example 6 in Part II.B above) from those that involve structured passive investments and that, in the case of multinational financial services companies, are unrelated to their businesses (Examples 4 and 5 in Part II.B above).

**Related vs. unrelated participants**. It also appears to be relevant—although not necessarily dispositive—whether the person that is benefiting from the non-U.S. tax treatment of the transaction is related or unrelated to the U.S. taxpayer.[125]

Depending on the circumstances, the presence of a *bona fide* participant that is unrelated to the U.S. taxpayer and is claiming benefits under foreign tax law may help establish a substantial business purpose and/or economic substance to the transaction,[126] which may be more difficult to do where the non-U.S. participant is related to the taxpayer.[127]

As noted in Part VI.A below, in the case of FTC separation structures (such as the *Guardian Industries* case or reverse hybrid structures), which result in the separation between foreign tax credits and the associated income, the fact that the participants are all related to one another is a negative factor in finding a justification for this result in the policies underlying the foreign tax credit. On the other hand, although the fact that the participants in a typical duplicate benefits arbitrage transaction are not related to one another should not necessarily immunize such transactions from being curbed, it does make it more difficult to conclude that such transactions are problematic because the U.S. participant derives nontax economic benefits in the form of compensation from the non-U.S. participant for the non-U.S. tax benefit.

### *5. The Legal Context*

The legal context of a particular international arbitrage transaction (or type of transaction) can also have a significant bearing on whether the transaction (or type) should be considered benign or troublesome as a tax policy matter.

One aspect of the legal context consideration is the substance and nature of the U.S. tax rule (or rules) that result(s) in or is (are) affected by the tax arbitrage. This can affect the analysis of whether there is anything wrong as a tax policy matter with the particular transaction and, if so, what exactly is the problem. In particular, understanding the U.S. tax rule (or rules) that result(s) in or is (are) affected by the tax arbitrage—and the legislative or regulatory history and judicial and regulatory interpretations of the rule(s)—can illuminate whether the arbitrage structure undermines any policy underlying the relevant substantive tax rule(s) or, instead, is consistent with other policies represented in the relevant tax rule(s). In addition, an appreciation of the legal context may shed light on the practical aspects, efficacy and wisdom of particular approaches to developing a remedy.

As noted in Part III above, international tax arbitrage transactions implicate specific substantive tax rules (such as the foreign tax credit, which is the focus of this paper), but also rely on specific techniques to achieve benefits under U.S. and foreign tax laws. These techniques include ownership arbitrage devices (such as repos), hybrid securities, hybrid entities and partnership allocations. The legal context consideration should take account of both the substantive tax rules and the specific arbitrage techniques.

A key issue to be addressed in considering the substantive tax rules and arbitrage techniques is whether those rules, as applied in the particular situation, produce results that are consistent or inconsistent with the policy fabric of the rules in question, either

individually or as they interplay with one another, and whether the arbitrage transaction undercuts the integrity and coherence of those rules individually or as they operate together. This point is implicitly borne out by the discussion in Parts VI and VII.H. below.

Another aspect of the legal context consideration is the provenance of the relevant rules and the degree to which the Treasury and the IRS have latitude to modify or interpret them. For example, depending on the issue and the circumstances involved, a treaty-based rule may raise special considerations that are not raised by statutory or regulatory provisions. These may include (i) the intent of the treaty partner at the time it negotiated the treaty,[128] (ii) the presence or absence of general provisions in the treaty that can be construed as limiting the availability of the treaty benefits in question, and (iii) the extent to which the treaty can be said to implement an agreed-upon single taxation principle with operative effect for the issue raised by the particular arbitrage transaction.

A final aspect of the legal context is the implications to be drawn, if any, from a comparison of the results under the particular international tax arbitrage transaction with actual and potential results that are attributable to the existence of manifold differences between tax systems as a result of the absence of an international harmonization of tax rules as well as the tax and economic policies of different countries. To illustrate, in considering a particular tax arbitrage transaction, it may be instructive to consider whether the tax savings to the participants that result from that transaction (and the loss of tax revenues to the respective governments) are quantitatively different from, or qualitatively more troublesome than, the tax savings (or loss of tax revenues) that arise as a result of disparities between countries in respect of other tax rules, such as tax rates, tax incentives, the definition and scope of the tax base or the percentage of the country's economic output that is absorbed by taxes.[129] Indeed, viewed from this perspective, one might well conclude that international tax arbitrage is a minor factor in the overall picture of the tax and economic environment, and hardly worth the attention it has been receiving.

### *6. Implementation and Administrability Considerations*

The design and implementation of a response to particular international tax arbitrage transactions, or to international tax arbitrage in general, are primarily secondary considerations, which become relevant following a determination that there is a problem that warrants a response.[130] However, from time to time, implementation and administrability considerations can also play a role in determining whether such transactions are sufficiently problematic to warrant a response altogether and in determining whether it is feasible to devise a workable rule. This is not to suggest that if there is a clear problem, it should not be addressed merely because the possible solutions are not optimal or raise issues of their own. Rather, implementation and administrability considerations can in certain situations help sharpen the focus on the factual and legal considerations discussed in Paragraphs 4 and 5 above.

In particular, all these considerations—implementation and administrability as well as the factual and legal contexts—to some extent involve drawing lines between the good and the bad, *i.e.,* between those transactions that are benign or even salutary, on the one hand, and those that are troublesome and should be curbed, on the other hand. In other words, most types of international tax arbitrage transactions and structures have common characteristics with one another and with other transactions and structures. Identifying those features or aspects that distinguish problematic transactions and structures from those that are not is essential both to determining which transactions and structures should be curbed and to implementing an approach to addressing those transactions. If and to the extent that it is difficult to distinguish the problematic transactions from those that are not, such difficulty may reflect not only on the practicality of devising an approach to addressing those transactions but also may suggest the elusiveness (or possibly, even the futility) of efforts to delineate properly what are the problematic cases and why they are troublesome.

Several related aspects of the administrability issue are relevant to the implementation of a solution to problematic situations. One aspect is whether it is feasible to devise an approach that appropriately matches the problematic situations and is not underinclusive or overinclusive. An underinclusive solution will interdict only some of the problematic transactions and structures, but will allow others to proceed. An overinclusive solution will adversely affect transactions and structures that are not troublesome, and could thereby interfere with normal business and investment activities.

A related aspect is whether a solution should be formulated through a technical rule, through a general anti-abuse rule, or through a combination thereof. A technical rule would prescribe a particular result for particular enumerated conditions, and typically would be targeted to one or more specific identified

problem cases. A general anti-abuse rule would be less precise in its conditions of application and, often, in its prescribed consequences. A fair assumption is that a poorly crafted technical rule is more likely to be underinclusive and that a poorly crafted general anti-abuse rule is more likely to be overinclusive, but examples of overinclusive technical rules and of underinclusive anti-abuse rules certainly do exist.

Another related aspect is whether the rule that is crafted—either as a technical rule or as an anti-abuse provision—is sufficiently clear and precise in its scope that it provides adequate guidance to taxpayers and IRS agents as to what is permitted and what is not. To the extent that a rule's scope is vague, it may be overinclusive in practice because it has a chilling effect on taxpayer behavior and/or provides a pretext for IRS agents to challenge transactions and structures that satisfy the requirements of the tax law.

A final related aspect is the compliance burden that the solution will impose on taxpayers, and the relationship between the incidence and extent of the compliance burden, on the one hand, and the magnitude of the problem to be solved, the efficacy of the solution, and the available alternatives, on the other.

In the case of international tax arbitrage, implementation and administrability considerations also implicate several international factors. Thus, if a type of international tax arbitrage transaction or structure is determined to be problematic because of the economic efficiency considerations discussed in Paragraph 1 above, it is relevant to evaluate the domestic and international economic, fiscal and political impact of particular approaches in devising a response. In addition, as with the U.S. tax system, the policies, practices and regulations of other governments will not necessarily remain static, and changes in U.S. tax rules to address problematic cases may need to anticipate (and sometimes be revised in response to) changes in the policies, practices and regulations of other governments.[131]

It is also appropriate to consider whether and to what extent bilateral and multilateral forums should play a role in addressing international tax arbitrage. This question is discussed further in Part VII.I below.

# VI. Policy Analysis of Foreign Tax Credit Arbitrage Transactions

This Part considers whether and, if so, in what respects, the FTC arbitrage transactions described in Part II are problematic as a policy matter. This analysis draws upon the policies underlying, and rules implementing, the foreign tax credit that are outlined in Part IV and the framework for evaluating international tax arbitrage transactions that is proposed in Part V. While it is difficult in some respects to separate the policy analysis from a discussion of practical implementation and administrability considerations, to the extent possible the discussion of those considerations is deferred to Part VII.

## A. FTC Separation Structures

FTC separation structures such as those described in Part II.A above—in which the foreign tax credit is separated from the tax base to which it relates, whether under the consolidated tax regimes of particular countries, the use of reverse hybrid entities, the use of hybrid securities, or other techniques—appear to be troublesome as a policy matter both from the perspective of the policies underlying the foreign tax credit outlined in Part IV and (albeit to a lesser extent) from the broader perspective of the framework for evaluating international tax arbitrage transactions that is proposed in Part V.

The principal policy objective underlying the foreign tax credit is to prevent double taxation of a taxpayer's foreign source income, and thereby to preserve neutrality between U.S. and foreign investment. Implicit in that objective and (as discussed below) in at least some of the rules implementing the foreign tax credit are the dual concepts that (i) the taxpayer should be subject to tax in the United States on the income to which the foreign tax credit relates (at the time and in the amount prescribed under the Code), and (ii) the taxpayer should be entitled to utilize the foreign tax as an offset, or credit, against such U.S. federal income tax. In other words, while the existing foreign tax credit rules do not contain an explicit provision requiring a direct matching between income (*i.e.,* the tax base) and the related foreign tax credit—and indeed, the averaging rule inherent in the "basket" approach on Code Sec. 904 and the technical taxpayer rule as it stands in the pre-2007 version of Reg. §1.901-2(f) allow for substantial mismatches between income and the related credit precisely in the context of FTC separation structures (as well as in other contexts)—in its purest conceptualization, the principal policy underlying the foreign tax credit would best be actualized through a matching principle.

Accordingly, it appears reasonable and appropriate as a policy matter to test FTC separation structures against a broad standard of the matching principle notwithstanding that, as discussed further below, a pure matching principle has not to date been viewed

in the foreign tax credit context as feasible or desirable for administrative and other reasons, and therefore has not been, and may never be, adopted. Viewed against that standard, the FTC separation structures are problematic because they permit, as a practical matter, a complete and indefinite separation between creditable foreign taxes and the related income.

Moreover, the existing foreign tax credit rules do give some effect to the matching principle, inasmuch as the Code Sec. 904 limitation, the Code Sec. 902 indirect credit rules and the rules for accommodating timing and absolute differences between U.S. and foreign tax bases can be viewed as manifestations of a matching principle. Thus, the Code Sec. 904 limitation mandates that there be an overall correspondence between the levels of foreign income and creditable foreign taxes, as well as between the income and creditable foreign taxes in particular baskets. In terms of the requisite relationship between the foreign source income and the associated foreign tax, the U.S. tax rules eschew an item-by-item matching in favor of a liberal basket approach. The rules thus permit cross-crediting of foreign taxes that are imposed at an effective rate that is greater than the U.S. tax rate against foreign source income in the same basket that are taxed at a lower effective foreign tax rate.[132] As a result, U.S. multinational groups routinely arrange their foreign subsidiaries, and time dividends therefrom, so as to maximize their ability to utilize foreign tax credits (for example, by optimally blending low-taxed and high-taxed streams of income within the same "basket"). Notwithstanding these significant opportunities for cross-crediting, however, the touchstone of the Code Sec. 904 limitation is a matching principle.

Similarly, the indirect credit under Code Sec. 902 has a matching rule for tracking creditable taxes and the earnings pool to which the taxes relate.[133]

The foreign tax credit rules also contain provisions designed to accommodate both timing and absolute differences between U.S. and foreign tax bases. In their broad purpose and effect, these rules are intended to allow a credit for foreign taxes in a manner that best matches those taxes to the related U.S. tax base, although in many cases the result may be the allowance of a credit with respect to a disproportionately small amount of income (as determined under U.S. tax principles).[134]

While each of these rules reflects a matching principle, these rules do not adopt a narrow tracking approach but instead allow for some separation between the creditable taxes and the related income base. Also, as noted above, the technical taxpayer rule as it stands in the pre-2007 version of Reg. §1.901-2(f) allows for substantial mismatches between income and the related credit precisely in the context of FTC separation structures (as well as in other contexts). The foregoing rules reflect a balance between a variety of policy and practical considerations. Consequently, it may reasonably be asked whether FTC separation structures should be considered problematic under the policies underlying the foreign tax credit.

To my mind, the separation between creditable foreign taxes and the related tax base that is achieved under FTC separation structures is qualitatively different from the type and degree of divergence that is countenanced under the foreign tax credit rules. As explained in the NYSBA Section 1.901(f)(3) Report:

> Each of the cross-crediting and other aspects of current law reflects a judgment on the part of Congress or the IRS as to how best to achieve a reasonable matching between a creditable foreign tax and the related tax base at an acceptable administrative cost, within the overall objective of preventing double taxation. None of the features of the current rules that allow cross-crediting permit a complete and indefinite separation between creditable foreign taxes and the related tax base. And the base/timing differences rules are designed to achieve the fairest result (*i.e.,* allowing a credit for foreign taxes) that is reasonably possible under the circumstances.
>
> By contrast, the situations under discussion create an artificial and indefinite mismatch between creditable foreign taxes and the related tax base, and unless there are compelling administrative considerations that require such a result, this result does not in any way advance—indeed, it subverts—the policy objectives of the foreign tax credit. Moreover, unless the Treasury and the IRS revise the regulations, an increasing number of taxpayers will likely exercise self-help to claim foreign tax credits without including the related tax base in income, thereby undermining the integrity of the foreign tax credit system.[135]

In this regard, the artificial and indefinite mismatch between creditable taxes and the related tax base that is achieved under FTC separation structures is achieved through allocations of credit and income among related persons in a manner that is inconsistent with the arm's-length principle of Code Sec. 482.[136]

In addition to providing regulatory authority for proposed Reg. §1.901-2(f), Code Sec. 482 undercuts the argument that FTC separation structures are consistent with the policies underlying the foreign tax credit.

FTC separation structures also appear to be problematic when viewed from the perspective of the policy framework laid out in Part V. Essentially, these structures permit a discrete group of taxpayers—those with multinational operations—to strip foreign tax credits from related income and to utilize those credits to offset residual U.S. tax on other foreign source income (which in turn can be maximized through various favorable sourcing rules).[137] While in theory the U.S. tax that was offset will be due when the related income is repatriated to the United States, in practice such tax can (and presumably will) be deferred indefinitely. This raises at least a perception of unfairness, since other taxpayers cannot similarly apply credits to reduce their U.S. tax burden. It might be contended that this result is not in fact unfair because it merely enables a taxpayer to mitigate the uneven burdens of higher- and lower-taxed foreign income so as to achieve an effective rate equal to the U.S tax rate, and that this result is achieved within the permitted rules for cross-crediting. However, on balance, this result appears to be unfair because, as discussed above, the complete and indefinite separation of foreign taxes from the related tax base is inconsistent with the matching principle that underlies the foreign tax credit as well as the arm's length principle.

Moreover, FTC separation structures appear to be inconsistent with the capital export neutrality principle that also underlies the foreign tax credit. This is because they enable a taxpayer to avoid paying U.S. tax on low-taxed foreign source income through the accelerated use of foreign tax credits attributable to other foreign source income that may never be repatriated, thereby making such low-taxed foreign business activities more attractive than U.S. business activities.

Thus, the pertinent question is whether it is feasible to revise the rules so as to prevent FTC separation structures without raising policy, practical or administrative problems. As discussed in Part VII.A below, the proposed revisions to Reg. §1.901-2(f) appear to answer that question in the affirmative.

## B. Duplicate Benefits FTC Arbitrage Transactions

Foreign tax credit arbitrage transactions that permit effective duplication of tax benefits (usually because the United States treats the U.S. participant as the owner of the entity that pays the foreign tax and allows it a foreign tax credit while a foreign country treats the non-U.S. participant as an owner of the entity) present especially difficult policy and practical challenges to the tax administrator. The first challenge, discussed in this Part, is to identify and articulate what, if anything, is wrong with these transactions as a policy matter. The second challenge, discussed in Part VII, is to formulate a coherent and properly tailored approach for curtailing the perceived abuse without adversely affecting legitimate activities.

In Notice 98-5, where the Treasury and the IRS first leveled their sights on duplicate benefits FTC arbitrage transactions, they expressed the following policy arguments against such transactions:

1. The foreign tax credit is designed to reduce the disincentive for taxpayers to invest abroad that would be caused by double taxation. In other words, the foreign tax credit is intended to preserve neutrality between U.S. and foreign investment and to minimize the effect of tax consequences on taxpayers' decisions about where to invest and conduct business.
2. The Code Sec. 904 limitation permits, to a limited extent, cross-crediting of foreign income that is taxed at a rate in excess of the applicable U.S. rate against foreign income that is taxed at a lower rate. The Treasury and the IRS are concerned that multinational corporations that are in an excess limitation position "may enter into foreign tax credit-generating schemes designed to abuse the cross-crediting regime and effectively transform the U.S. worldwide system of taxation into a system exempting foreign source income from residual U.S. tax.
3. This result is clearly incompatible with the existence of the detailed foreign tax credit provisions and cross-crediting limitations enacted by Congress. No statutory purpose is served by permitting credits for taxes generated in abusive transactions designed to reduce residual U.S. tax on low-taxed foreign-source income. The foreign tax credit benefits derived from such transactions represent subsidies from the Treasury to taxpayers that operate and earn income in low-tax or zero-tax jurisdictions. The effect is economically equivalent to the tax sparing benefits for U.S. taxpayers that Congress and the Treasury have consistently opposed in the tax treaty context because such benefits are inconsistent with U.S. tax principles and sound tax policy.
4. In abusive arrangements involving duplicate

> benefits arbitrage transactions, the U.S. taxpayers exploit the inconsistencies between U.S. and foreign tax law "where the expected economic profit is insubstantial compared to the foreign tax credits generated.

Evidently, in 1998 the Treasury and the IRS thought that duplicate benefits FTC arbitrage transactions were abusive only (or primarily) where they produced insubstantial economic profit compared to the tax credit benefits. In addition, based on points 2 and 3 and the examples in the Notice, the concern seems to have been limited to situations in which the taxpayer is in an excess limitation position and is utilizing the arbitrage transaction to generate credits that can shelter other foreign source income (*i.e.,* hyped credit transactions). Indeed, the first paragraph of the Notice indicates that its focus is on "abusive tax-motivated transactions with a purpose of acquiring or generating foreign tax credits that can be used to shelter low-taxed foreign-source income from residual U.S. tax."

Thus, the Notice strongly implies that duplicate benefits FTC transactions that do not involve abusively hyped credits generally are not problematic. There is no indication that the Treasury and the IRS changed their view in 2004 (when they issued Notice 2004-19), so as to consider all or virtually all duplicate benefits FTC arbitrage transactions fundamentally abusive. Notice 2004-19 withdrew Notice 98-5 and replaced the earlier Notice's "enhanced economic profit test" for examining such transactions[138] with an amorphous approach that would scrutinize such transactions under the following principles of existing law: "the substance over form doctrine, the step transaction doctrine, debt-equity principles, Code Sec. 269, the partnership anti-abuse rules of § 1.701-2, and the substantial economic effect rules of § 1.704-1."

In May 2006, IRS Commissioner Everson submitted a report to the Senate Finance Committee on compliance concerns relating to the Large and Mid-Size Business Division, in which he highlighted abusive foreign tax credit transactions. He mentioned FTC separation structures and then stated:

> In addition, cross-border financing transactions are being structured to generate abusive FTC results. In the case of U.S. lender transactions, a U.S. person makes a loan to a foreign person in a transaction structured to shift a portion of the borrower's foreign tax liability to the U.S. lender. In the case of U.S. borrower transactions, a U.S. person borrows from a foreign person in a manner that allows the U.S. person to pay creditable foreign taxes in lieu of deductible interest. In both types of cases, the FTCs are used to shelter unrelated foreign source income. These structured financing transactions often result in the duplication of tax benefits through the use of certain structures designed to exploit inconsistencies between U.S. and foreign laws. We are aware of 11 structured financing transactions with an estimated $3.5 billion at issue in these cases.[139]

So how should duplicate benefits FTC arbitrage transactions be regarded as a tax policy matter—as a category of fundamentally abusive transactions or as a category of legitimate transactions that may from time to time include aggressively structured, abusive transactions? Should the determining factor be whether the transaction involves hyped credits and cross-crediting or, instead, is merely self-sheltered? Should it be relevant (as Commissioner Everson's report seems to suggest) whether the joint investment entity holds debt instruments issued by the U.S. or non-U.S. participants or their affiliates? Let us begin tackling these questions by considering the arguments advanced in Notice 98-5 before turning to other relevant considerations.

### *1. Capital Export Neutrality*

The first point made in Notice 98-5—that the foreign tax credit is intended to achieve capital export neutrality by minimizing the effect of tax consequences on (U.S. vs. offshore) investment decisions—seems uncontroversial. However, it also appears beyond cavil that a taxpayer has not engaged in an abusive transaction merely by investing abroad because its after-tax economic return is higher than if it had invested in the United States. As already noted, a significant attraction of many duplicate benefits FTC arbitrage transactions (and certainly those that are merely self-sheltered)[140] is the low-cost financing (or enhanced investment return) that the foreign counterparty is providing to the U.S. taxpayer. This very real financial benefit—a payment from the foreign counterparty typically in the form of a reduced financing cost or enhanced investment return—is what provides the taxpayer with a higher after-tax return; at least in the case of self-sheltered transactions, the foreign tax credit is simply the neutralizing factor that places the taxpayer in the same tax position that it would have been in had it made the investment in the United States.

The fact that this financial benefit happens to arise because the foreign counterparty is willing to pay for the non-U.S. tax benefit that it enjoys due to the different tax treatment of the transaction in its home country should not, by itself, make the transaction abusive. Surely, the principle of capital export neutrality would not have been violated if the taxpayer decided to invest offshore because its foreign counterparty was prepared to compensate it for other economic benefits that the foreign counterparty realizes (*e.g.,* synergies between this transaction and other business activities of the foreign counterparty, or access to cheap financing sources). Conceptually, there does not appear to be a persuasive justification for distinguishing between tax benefits to the counterparty arising under foreign law and other economic benefits that it might derive.[141]

### *2. Cross-Crediting*

The second point made in Notice 98-5—that a taxpayer in an excess limitation position might seek to maximize its foreign tax credit position by making additional investments that are expected to generate relatively high-taxed foreign income in the same "basket" as the excess limitation and thereby achieve cross-crediting to the extent permitted under Code Sec. 904 and the regulations thereunder—merits some discussion.

First of all, the cross-crediting concern is not implicated in the many duplicate benefits FTC arbitrage transactions (such as the transaction depicted in Example 4) in which the investment is only self-sheltered by the foreign tax credit, and does not generate excess credits that are used to shelter other lower-taxed foreign income of the taxpayer. So if all (or virtually all) duplicate benefits FTC arbitrage transactions are to be declared abusive, that will need to be for other reasons.

Second, cross-crediting within the parameters permitted by the basket rules of Code Sec. 904 hardly seems to be sinister or abusive, at least in the absence of other troublesome factors, but rather prudent tax planning of the sort that occurs daily. Notice 98-5 appears to acknowledge this, but expresses concern that certain taxpayers "may enter into foreign tax credit-generating schemes designed to abuse the cross-crediting regime" by entering into "abusive transactions designed to reduce residual U.S. tax on low-taxed foreign-source income," thereby obtaining inappropriate "subsidies from the U.S. Treasury" that are "economically equivalent to the tax sparing benefits for U.S. taxpayers that Congress and the Treasury have consistently opposed in the tax treaty context." Cutting through the rhetoric, the sole objective criterion set forth in the Notice for distinguishing abusive "schemes" from acceptable cross-crediting is whether the expected economic profit is insubstantial, compared to the foreign tax credits, as determined under an enhanced economic profit test, which is discussed in Paragraph 3 and Part VII.E, below, and was withdrawn by Notice 2004-19.

Third, as discussed above,[142] duplicate benefits FTC arbitrage transactions with hyped credits typically are a result of the interplay between the foreign tax credit and the rules for allocating interest expense for purposes of the Code Sec. 904 limitation. Often the transactions themselves have significant leverage that generates deductible interest expense for U.S. tax purposes but nondeductible payments in respect of equity for foreign tax purposes. However, the level of cross-crediting can be affected by factors extraneous to the particular transaction, including (i) whether, for example, the U.S. participant is a highly leveraged financial institution, a special purpose deconsolidated subsidiary or a multinational with a relatively low leverage ratio; and (ii) the manner in which the U.S. participant's investment in the transaction is funded. The interplay between the foreign tax credit and the interest allocation rules is already the subject of a complicated set of rules,[143] and any efforts to measure the amount of cross-crediting and to distinguish between "good" and "bad" cross-crediting raise extraordinarily difficult implementation issues.[144] On a policy level, however, it is appropriate to consider such questions as (i) whether, when and why leverage (and the related interest expense) is troublesome in the context of the foreign tax credit[145]; (ii) how does one reconcile a position that leverage may be troublesome in that context (at least in certain circumstances) with the fact that for numerous compelling commercial reasons, financial institutions are highly leveraged and their positions in financial assets—including those that generate foreign tax credits—are necessarily and invariably highly leveraged (with traced funding and/or as a result of the high overall leverage of the financial institution); and (iii) is it appropriate (and, venturing for a moment into implementation concerns, feasible) to draw distinctions regarding the treatment of leverage and foreign tax credits that depend on such factors as the nature of the transaction or taxpayer or the source of the leverage?

Fourth, the cross-crediting and hyped credit transactions arguably raise a policy consideration similar to that discussed in Part VI.A above in the context of FTC separation structures—*i.e.,* the extent to which there

is or should be a matching principle that more closely associates the foreign tax credit with the related income than the "basket" rules under Code Sec. 904.[146] This issue is explored further in Part VII.H below, but at this juncture it is important to note that in the absence of Congressional revisions to Code Sec. 904, the policy grounds for interdicting duplicate benefits FTC arbitrage transactions involving cross-crediting on the basis that they are inconsistent with a matching principle appear to be considerably weaker than the similar policy grounds (discussed in Part VI.A above) for interdicting FTC separation structures. Whereas FTC separation structures effect a complete and indefinite separation between the tax and the related tax base, duplicate benefits FTC arbitrage transactions achieve cross-crediting within the parameters and technical requirements that have been established by an elaborate statutory and regulatory scheme. Moreover, unlike hyped credit duplicate benefits FTC arbitrage transactions, FTC separation structures involve related parties and are therefore vulnerable as a policy matter for achieving a mismatch that is inconsistent with the arm's-length principle.

Fifth, in light of some of the other considerations discussed below, Congress or the Treasury/IRS might reasonably conclude that at least those duplicate benefits FTC arbitrage transactions that involve significant or abusive cross-crediting and hyped credits (however defined) should be curbed notwithstanding that they fall within the ambit of cross-crediting that is permitted under Code Sec. 904. In that event, the implementation considerations discussed in Parts VII.D and E below will be relevant, including considerations relevant to identifying when there is potentially troublesome cross-crediting and the extent thereof, as well as considerations relevant to developing an objective standard for identifying those hyped credit transactions that are to be curbed and those transactions that involve an acceptable degree of cross-crediting.

### *3. Insubstantial Economic Profit*

As indicated, it appears that, under Notice 98-5, the offensive aspect of the duplicate benefits FTC arbitrage transactions described in the Notice is what is stated in point 4—that in certain abusive transactions, the U.S. taxpayers exploit the inconsistencies between U.S. and foreign tax law "where the expected economic profit is insubstantial compared to the foreign tax credits generated." However, in order to arrive at that conclusion and thereby possibly to tag more than a relatively small percentage of transactions (*i.e.,* the "outliers") as abusive, one needs to revive the enhanced economic profit test[147] that was announced in Notice 98-5 but subsequently abandoned (for good reason) in Notice 2004-19, or to develop a substitute test. Moreover, even if one were to apply Notice 98-5's enhanced economic profit test to these transactions, based on my experience many of the transactions would pass muster because it is not uncommon or impractical for transactions to be structured with a view to satisfying that test.

### *4. Taxpayer Does Not Bear Economic Cost of Tax*

Moving beyond the rationale set forth in Notice 98-5 to consider other aspects of duplicate benefits FTC arbitrage transactions, the fact that the U.S. taxpayer likely does not bear the economic cost of the foreign taxes, or at least the portion thereof that corresponds to the compensation that it receives from the non-U.S. participant (whether by way of a reduced financing cost on funds provided by the non-U.S. participant, enhanced yield on the investment or an outright payment from the non-U.S. participant for the foreign tax benefits), might as an abstract policy matter conceivably justify denial of all or a portion of the foreign tax credit. It would, however, require a fundamental modification of the principles and rules governing the foreign tax credit (as described in Part IV above) to make the creditability of foreign taxes turn on the extent to which the U.S. taxpayer has borne the economic impact of the foreign tax.[148] Moreover, given the difficulty of measuring who bears the economic impact of a tax and to what extent,[149] such an approach would clearly be unworkable.

### *5. Duplicate Benefits*

Duplicate benefits FTC arbitrage transactions may be considered troublesome on the grounds that they involve duplicate benefits—*i.e.,* that the tax benefits associated with the ownership of the underlying assets are being claimed in two countries, with the U.S. taxpayer claiming a foreign tax credit and the non-U.S. participant claiming a foreign tax credit (where the taxes are paid to a third country), a participation exemption, imputation credit, dividends received deduction or other benefit. This proposition needs to be examined from several perspectives.

The absence of harmonization between the tax rules of the corporate income tax and the overall tax systems of different countries is an acknowledged and accepted phenomenon.[150] Indeed, as noted above, when

compared to other disparities between tax systems of different countries, one might well conclude that international tax arbitrage is a minor factor in the overall picture of the tax and economic environment, and hardly worth the attention it has been receiving.[151]

Moreover, most situations in which the U.S. tax characterization or treatment of a transaction, structure or arrangement differs from the characterization or treatment under a different country's tax rules are not considered to be problematic, much in the same way as most differences between the U.S. tax characterization of a transaction, structure or arrangement and its characterization under accounting, insolvency, regulatory, or other legal rules generally are viewed neutrally as a tax matter.[152]

It is conceivable that the scrutiny that is now being given to international tax arbitrage would result in a conclusion that any situation in which duplicate tax benefits are being claimed is abusive, but that would be a remarkable development, and presumably would be largely unsatisfactory as a tax policy matter.[153] Such a rule would be an extreme application of the "single tax principle" in a manner that always deferred to the applicable foreign country's tax rules as to the characterization of the transaction, structure or arrangement (at least insofar as it relates to the eligibility of the U.S. taxpayer to claim the tax benefits arising under the U.S. tax characterization). It would impose a heavy burden on U.S. taxpayers to ascertain (and on the IRS to review) the foreign tax consequences of every transaction, structure or arrangement involving a foreign participant in order to determine whether duplicate benefits were being claimed and to identify and quantify those benefits, apart from presenting difficult interpretational issues as to what constitutes a duplication of tax benefits. And if the operative rule that were to emerge from such a view is that some or all of the U.S. tax benefits are disallowed if there are duplicate benefits abroad, it would likely have a negative impact on many classes of transactions, structures and arrangements with non-U.S. participants, thereby distorting economic decisions by disfavoring cross-border activities.

Assuming, therefore, that the mere fact that there is a difference between countries in respect of the tax characterization of a transaction is not viewed as the problem, it would be necessary to articulate a standard for drawing a distinction between those situations in which duplicate benefits are acceptable as a tax policy matter and those in which they are not. More pointedly, what is the objective standard or rationale under which some such tax arbitrage situations are considered acceptable as a tax policy matter while duplicate benefits FTC arbitrage (and presumably certain other) transactions are not?

In this regard, it does not appear fruitful to base such a standard on whether the duplicate tax benefit arises because there is duplicate tax ownership (*i.e.,* a different, single tax owner under each of two different tax regimes), or on whether this duplicate tax ownership is the result of a particular structuring technique (*e.g.,* a repo or hybrid security). Double dip leasing and duplicate benefits FTC arbitrage transactions share as a common feature the use of structuring techniques (such as a repo) that result in each of the U.S. and the non-U.S. participant being regarded as the owner of the relevant asset for purposes of the respective participant's tax law. To date, traditional double dip leasing (involving the financing of U.S. assets) is generally not considered problematic as a U.S. tax policy matter (except perhaps in some academic circles).[154] Evidently, then, neither the fact that a repo is treated as a financing for U.S. tax purposes but as a current sale and a forward contract to re-sell under the tax laws of some other countries, nor the fact that this technique results in duplicate tax ownership, is by itself (or together) viewed as warranting that the U.S. participant be denied the U.S. tax benefits of ownership.

Moreover, as discussed in Part III.A above, the characterization of repos and hybrid securities for U.S. tax purposes reflects substantive U.S. tax law policies and judgments as to the proper U.S. tax treatment of such agreements and instruments. In addition, these characterizations are deeply ingrained in the law and in commercial practice, and are relied upon by taxpayers and the IRS as the basis for commonly accepted, nonabusive transaction structures involving trillions of dollars of securities. So it does not appear productive to base a standard on the presence of duplicate tax ownership or of particular structuring techniques that produce that result.

Nor does it appear, at least at first blush, fruitful to base such a standard for distinguishing between duplicate tax benefit situations that are acceptable and duplicate benefits FTC arbitrage (and presumably other) transactions that are not acceptable on the nature of the tax benefits that are generated. Putting aside potential differences in their impact on U.S. tax revenues,[155] there does not appear to be a conceptual or policy reason to distinguish between a foreign tax credit, a dividends received deduction or an interest, depreciation or other deduction. Moreover, insofar as duplicate benefits FTC

arbitrage transactions are concerned, as mentioned in Paragraph 1 above, it is difficult to distinguish conceptually between the financial payment made by the non-U.S. counterparty for the use of the non-U.S. tax benefits and a financial enhancement that a non-U.S. counterparty might provide due to synergies, access to cheap financing or other intangible benefits that it might derive. On the other hand, it is worth considering whether there is something in the nature of the foreign tax credit as conceived under the Code that justifies curbing duplicate tax benefits transactions in which the U.S. party is claiming a foreign tax credit.

### *6. The Nature of the Foreign Tax Credit*

Certainly, because the foreign tax credit is a matter of legislative grace, eligibility therefore should generally be narrowly construed and a taxpayer must establish that it meets all applicable conditions and limitations.[156] While we have posited at the outset that the FTC arbitrage transactions under consideration fully satisfy the technical requirements of the tax law, the Treasury and the IRS may reasonably examine these transactions in light of the policies underlying the foreign tax credit (as well as broader tax considerations) and determine that these transactions should be curbed in order to more fully implement those policies.

Focusing only on the policies and considerations that are directly related to the foreign tax credit, for the reasons mentioned above in this Part VI.B, I do not believe that duplicate benefits FTC arbitrage transactions, as a class, are or should be vulnerable as a policy matter on the grounds that (i) they violate the export neutrality principle, (ii) there is improper cross-crediting, (iii) the expected economic profit is insubstantial compared to the foreign tax credits generated, or (iv) the taxpayer is not bearing the economic burden of the tax (although, as noted, it might be appropriate to curb those transactions that involve significant or abusive cross-crediting). At this juncture, however, it is appropriate to consider several additional considerations—(a) whether the foreign tax credit necessarily implies (or should imply) an indifference as a policy matter between creditable foreign taxes and U.S. tax, and (b) the relationship between that question and the requirement that the foreign tax be compulsory.

In Part V, Paragraph 1, above, I noted that the foreign tax credit is a product of the capital export neutrality principle, and that "an important by-product of that principle is that it does not make a difference as a matter of international economic efficiency whether the host (*i.e.,* source) country or the home (*i.e.,* residence) country collects the tax." While the myriad conditions and limitations (summarized in Part IV) that the Code and regulations place on the foreign tax credit reflect a number of different policy considerations, by no means do they evince an intention to depart from this by-product of capital export neutrality. Thus, a fair interpretation of the current U.S. tax landscape is that although the Code does contain incentives for domestic investment (as well as provisions to enable U.S. multinationals to compete abroad), at least in the foreign tax credit arena the overall operative guideline is studied neutrality between domestic and foreign investment. Indeed, as previously noted, the purpose of the foreign tax credit is to place foreign investment on an equal footing with domestic investment by removing the strong disincentive that would otherwise exist to invest overseas. That is not to say that there have not been and will not be modifications in the technical rules of the foreign tax credit to strike the appropriate balance on particular aspects of the foreign versus domestic equation, but simply that the overall thrust has been for the foreign tax credit rules to maintain neutrality between domestic and foreign investment decisions.

This studied neutrality may be appropriate as a policy matter, but it is not necessarily obvious or inevitable that this approach must be applied, without limits, to every situation. On a visceral level, one possible objection to many duplicate benefits FTC arbitrage transactions is that it appears that the U.S. taxpayer has deliberately chosen to structure its investment in certain passive assets through an entity and/or in a manner that is subject to foreign net income tax, where it just as well could have invested directly in those passive assets in a manner that avoided the foreign tax.[157] True, under current law, taxpayers are generally free to choose the location (U.S. vs. foreign) and form (*e.g.,* corporation or pass-through entity) by which they organize their business and investment activities.[158] Nonetheless, viewed from this perspective, Congress or the Treasury/IRS might well conclude that as a policy matter the United States should not be encouraging the payment of creditable foreign income taxes instead of U.S. income taxes where the choice of location and form of organization and /or operation of the investment entity ostensibly is driven primarily by tax considerations.

In other words, Congress or the Treasury/IRS might take the position that neutrality between payment of foreign and U.S. income taxes should be reserved for those situations in which there is a sufficiently weighty

business reason to organize and operate an investment activity in a manner that incurs net foreign income tax. Indeed, the "voluntary" incurrence of foreign tax seems to be the principal concern of the Treasury and the IRS in respect of so-called U.S. lender transactions, U.S. borrower transactions and asset parking transactions (discussed in Part VI.B.11 below).[159]

Stated somewhat differently, it could be argued that the concept that a tax is not creditable if it is not compulsory[160] should be expanded to encompass the use of a foreign entity or foreign investment structure to achieve duplicate tax benefits in the absence of substantial non–tax-related business reasons.

A significant issue with identifying the problem with duplicate benefits FTC arbitrage transactions as being the "voluntary" incurrence of foreign tax is the problem of differentiating between acceptable and abusive situations. This is not merely a question of line-drawing, practical administration and administrability, but of identifying (i) which foreign taxes are "voluntarily" incurred and which are not; and (ii) whether the "voluntary" incurrence of foreign tax is really the problem.

Recent comments by IRS officials suggest that the Treasury/IRS might be inclined as of now to treat only so-called U.S. lender transactions, U.S borrower transactions and asset parking transactions (discussed in Part VI.B.11 below) as abusive cases of "voluntary" incurrence of foreign tax. While such an approach may facilitate a straightforward, administrable demarcation between acceptable transactions and those that will be deemed abusive, the conceptual basis and policy rationale for this distinction may be questioned.

To illustrate this point, consider the fact that many U.S.-based financial institutions have substantial operations around the world, and that they acquire financial assets and obtain funding through offices and legal entities that are located or organized in various countries. Today the tax law does not second-guess the business decisions of such a financial institution as to whether to make a loan from the United States and incur a 35-percent federal income tax or, instead, to make a loan from its U.K. branch or U.K. subsidiary and incur a 30-percent U.K. tax and a five-percent U.S. federal income tax (after taking account of the foreign tax credit).[161] Suppose a U.K. borrower or lender proposes that a loan from one party to the other be structured utilizing a special purpose U.K. entity so as to enable the U.K. party to claim U.K. tax benefits for which it will compensate the U.S financial institution. Suppose further that the U.S. financial institution decides to enhance its yield and, incidentally, to increase its U.S. tax payments (by the amount of tax on the incremental yield) by entering into such a duplicate benefits FTC arbitrage transaction, but that in any event it just as likely as not might have determined to make the loan from its U.K. branch or subsidiary. Is it really appropriate as a policy matter to conclude that the choice of the particular transaction structure should be considered "voluntary" and troublesome, given that the basic decision to make the loan from a U.K. branch or an existing U.K. subsidiary—the sort of decision that is made countless times every day, and which is often driven largely by the location of the counterparty and the financial institution's personnel that negotiate the loan transaction, as well as regulatory, legal and other nontax reasons, but may also take into account the tax position of the financial institution in the United Kingdom and the United States—is not considered to be "voluntary" or troublesome despite the fact that it will substitute a foreign tax credit for a tax payment to the Treasury? And why is the decision to structure the loan to accommodate the U.K. counterparty and thereby to enhance the U.S. participant's yield not a sufficiently weighty business reason for adopting a particular investment structure? Furthermore, in this regard, on what basis might Congress or the Treasury/IRS promulgate standards for determining whether a particular loan, investment or borrowing is or is not in the ordinary course of business of a financial institution, which presumably is relevant for ascertaining whether there is a sufficiently weighty business reason for a transaction?

Other obvious questions regarding what is "voluntary" for this purpose include: Should a duplicate benefits FTC arbitrage transaction involving a repo over shares of a foreign entity automatically be acceptable if the entity holds a foreign operating subsidiary of the U.S. multinational rather than a pool of passive assets (*i.e.,* the entity is the holding company for a foreign operating subsidiary, or perhaps the foreign operating subsidiary itself, as in Example 6 in Part II.B above), since in that case the foreign tax would not be "voluntary"? If that is the case, should it also be acceptable if the entity is a special purpose vehicle that invests in debt instruments of the U.S. multinational's foreign subsidiaries, instead of in their equity? And what if it invests in equity, but the equity is preferred stock? Should it make a difference if the entity lends the proceeds to the U.S. multinational (rather than to foreign

affiliates) for use in its foreign business? Should it make a difference whether the U.S. multinational (or its foreign subsidiary) is a widgets manufacturer or a financial institution? In the case of a financial institution, should it make a difference whether the proceeds are used to purchase inventory or for proprietary investments, whether those assets are U.S. or foreign securities, and/or whether or not those assets are held by a foreign securities dealer subsidiary? Returning to the original question, if a repo of stock of a foreign operating company (whether a widgets manufacturer or a financial institution) should also be curbed, what is "voluntary" about the choice of investment entity or structure in that case?

In any event, as previously discussed, if the benefit that the U.S. taxpayer derives in any of the foregoing cases is a payment from an unrelated participant for the non-U.S. tax benefit (in the form of a reduced financing cost on funds provided by the non-U.S. counterparty, enhanced yield on the investment or an outright payment from the non-U.S. counterparty for the foreign tax benefits), why is such an economic benefit not a sufficiently weighty business reason for the U.S. taxpayer to engage in the transaction through a structure that incurs a foreign income tax? In other words, why should such an economic benefit be treated differently than other economic benefits for which a non-U.S. counterparty would be expected to compensate the U.S. party and which would typically be viewed as legitimate reasons for adopting a structure that incurs foreign income tax (*e.g.*, synergies between this transaction and other business activities of the foreign counterparty, or access to cheap financing sources)?

The foregoing questions do not necessarily preclude a policy determination to curb duplicate benefits FTC transactions where the foreign taxes are "voluntary," but they illustrate some of the conceptual and practical issues that such an approach presents. Practical implementation aspects of such an approach are considered further in Part VII.C.1 below.

### *7. Impact on Tax Base and Tax Revenues*

Closely related to the question whether duplicate benefits FTC arbitrage transactions should be curbed on the grounds that the foreign tax is, at least in some respects, "voluntary" is the question whether these transactions reduce U.S. tax revenues in a manner or for reasons that should not be permitted. The answer to this question is more complicated than it would appear, and depends to a great degree on what is the appropriate set of assumptions as to the alternative investments that would have been made—either by the particular taxpayer or, in general, by the class of similarly situated taxpayers—in lieu of investing in a duplicate benefits FTC arbitrage transaction. In other words, if the taxpayer (or similarly situated taxpayers generally) were denied the enhanced after-tax return from investing in the FTC arbitrage transaction, what investment would the taxpayer(s) have made instead? Would the taxpayer(s) nonetheless have made an investment that would subject it/them to foreign tax and thus would have claimed the foreign tax credit (in which case, the duplicate benefits FTC arbitrage transaction generally would increase its/their U.S. tax from that baseline since the taxpayer(s) would pay additional U.S. tax on the economic benefit provided by the non-U.S. counterparty), or, instead, would the taxpayer(s) have made a domestic investment? Furthermore, if the taxpayer(s) would have made a domestic investment, would it have been a fully taxable investment or would it have been a tax-exempt or tax-advantaged investment?

### *8. Lessons from the Disallowance of DCLs Under Code Sec. 1503(d)*

In considering the policy aspects of duplicate benefits FTC arbitrage transactions, one cannot avoid comparing those transactions to another type of international arbitrage transaction in respect of which Congress acted to prevent duplicate tax benefits—the dual consolidated loss (DCL) transactions. In a DCL transaction, a taxpayer would organize a dual resident corporation (DRC)—*i.e.*, a company that is tax resident in two countries, for instance the United Kingdom and the United States. This is possible because those countries have different rules for determining tax residency—the place of incorporation in the case of the United States and the place of "management and control" in the case of the United Kingdom. Prior to the enactment of anti-DCL rules by the United Kingdom and the United States, if a DRC were a member of a U.S. consolidated group as well as of a group that is eligible for U.K. group relief and that DRC were to borrow money, the interest expense could be claimed as a deduction against the taxable income of both the U.S. and U.K. tax groups. Of concern to Congress, a DRC organized by a U.K. multinational company could borrow money to fund the acquisition of a U.S. target corporation, and could deduct the interest expense twice, against income earned by the U.K. group and against income earned by the newly acquired U.S. target group, thereby en-

joying a competitive advantage over a potential U.S. acquirer.[162] Congress enacted Code Sec. 1503(d) to prohibit a DCL from being used to offset income of another member of its U.S. consolidated tax group. Primarily because of a concern that the provision might otherwise be deemed to violate treaty anti-discrimination provisions, Congress made the provision reciprocal, so that it applies whether the parent of the DRC is a U.K. or a U.S. corporation.[163]

Code Sec. 1503(d) arguably could be viewed as a clarion Congressional policy pronouncement against transactions, structures and arrangements in which tax benefits are claimed in two countries.[164] That view, however, appears to be incorrect, for several reasons. First, as just noted, the DCL rule was animated by a tangible political and economic concern about the competitive disadvantage that U.S. acquirers faced in bidding against companies from the U.K. and certain other countries, and was extended to outbound situations primarily out of concern that otherwise Congress' remedy for inbound transactions would be overturned by the courts. Thus, the DCL rule hardly stands as a clarion pronouncement on international tax arbitrage transactions that generate duplicate benefits. Second, Congress has thus far refrained from passing a broad rule (or even other targeted rules) that would deny U.S. tax benefits whenever tax benefits were also being claimed in another country, including most recently when it addressed cross-border LILO transactions in Code Sec. 470. Moreover, it is doubtful that Congress would seriously contemplate adopting a general rule denying tax benefits (including foreign tax credits) to a U.S. taxpayer in every case where a foreign taxpayer also derived tax benefits for foreign tax purposes without carefully considering the complex policy issues that such transactions raise.[165]

Indeed, the sad history of Code Sec. 1503(d) stands as an instructive exhibit and warning as to the challenges of addressing international tax arbitrage transactions. Today, 20 years after the enactment of Code Sec. 1503(d), foreign acquirers can and do readily "double dip" on interest expense in acquiring and funding their U.S. affiliates, by organizing the parent of the U.S. group as a reverse hybrid entity and having that entity borrow funds from unrelated banks or the capital markets. Even though the interest expense is deductible in computing the taxable income of both the U.S. and foreign consolidated groups, Code Sec. 1503(d) does not deny an interest deduction because that provision (and the extraordinarily complex regulations thereunder) apply only if the domestic corporation itself is subject to foreign net income tax on a residence basis.[166] But while Code Sec. 1503(d) has failed abysmally to serve its principal purpose, it has far-reaching, anti-competitive, counter-intuitive, punitive and in many respects unintended consequences for U.S. multinationals, which are subjected to a mind-numbingly complex set of regulations pursuant to which they are often denied the ability to claim economic losses in respect of their investments in foreign branches, partnerships and disregarded entities, not only in situations where those losses produce a current foreign tax benefit but also in situations in which such a benefit is only a far-fetched theoretical possibility.[167]

### *9. Comparison to Reverse FTC Arbitrage and U.S. Withholding Tax Claims Transactions*

In addition to duplicate benefits FTC arbitrage transactions, Part II describes two other categories of transactions that involve duplicate tax benefits.

In reverse FTC arbitrage transactions (*see, e.g.*, Example 7 in Part II.C above), the investment entity is subject to U.S. federal income tax, and the U.S. taxpayer receives its return from the entity without tax because, alternatively, (i) the U.S. taxpayer is eligible for the 100-percent dividends received deduction, (ii) the investment entity is a member of the U.S. taxpayer's consolidated tax group, or (iii) the U.S. taxpayer will eventually liquidate the investment entity under Code Sec. 332 after the foreign counterparty is no longer a participant. The foreign counterparty is treated as tax owner of the investment entity under its (non-U.S.) tax law, for example as a result of a repo, and compensates the U.S. taxpayer (typically by providing low-cost financing, an enhanced investment yield, or a payment) for the foreign tax benefits that it enjoys.

In transactions involving U.S. withholding tax claims by foreign counterparties (*see, e.g.*, Example 8 in Part II.D above), the investment entity pays U.S. withholding tax on payments to the foreign counterparty in respect of its investment in the entity. The foreign counterparty claims a credit in its home country for the withholding tax, and compensates the U.S. taxpayer (typically by providing low-cost financing, an enhanced investment yield, or a payment) for the foreign tax benefits that it enjoys. Because, however, the U.S. taxpayer is treated as the beneficial owner of the interest that is nominally held by the foreign counterparty and as borrowing money from the foreign counterparty in a transaction that is eligible for the portfolio interest exemption, the U.S. taxpayer will obtain a refund of the U.S. withholding tax (or will credit such tax against its tax liability).

These transactions are quite similar to duplicate benefits FTC arbitrage transactions in that they all involve (i) the payment of one level of tax in respect of an investment or income stream, (ii) both the U.S. taxpayer and the non-U.S. counterparty claiming the tax benefits of ownership due to inconsistent characterization of the transaction for U.S. and foreign tax law purposes, and (iii) the foreign counterparty compensating the U.S. taxpayer (typically by providing low-cost financing, an enhanced investment yield or a payment) for the foreign tax benefits that it enjoys. In all these situations, from the perspective of the U.S. taxpayer, it has paid one level of (foreign and/or U.S.) tax on economic income, but has enhanced its overall return by the amount of the compensation that it received from the foreign counterparty. From the perspective of the Treasury, however, the duplicate benefits FTC arbitrage transaction deprived it of revenue whereas the reverse FTC arbitrage and U.S. withholding tax claims transactions did not.

In considering how to address these situations, the Treasury and the IRS could take the position that their primary concern is to preserve the U.S. tax base and tax revenues, and accordingly, they will curb only duplicate benefits FTC arbitrage transactions. Alternatively, if and to the extent that there is a market for reverse FTC arbitrage transactions and U.S. withholding tax claims transactions, the continued existence of those (and perhaps other tax arbitrage) transactions may suggest that nothing should be done to curb duplicate benefits FTC arbitrage transactions because the baseline for assessing whether indeed such transactions deprive the Treasury of revenue that it otherwise would have had should take into account (under the rationale set forth in Paragraph 7 above) the availability to U.S. taxpayers of these alternative investments. Additionally, the Treasury and the IRS could conclude that reverse FTC arbitrage transactions and U.S. withholding tax claims transactions should be curbed as well because of the perception of abuse consideration discussed in the next Paragraph.

### *10. Fairness, the Perception of Abuse and Tax Administration of Highly Structured Tax-Driven Transactions*

As mentioned in Part II, many duplicate benefits FTC arbitrage transactions involve U.S. taxpayers that are financial institutions, and those transactions that do not involve financial institutions typically involve sophisticated U.S. multinationals with foreign source income. Regardless of whether these transactions should be curbed as a policy matter under the considerations laid out in the previous nine Paragraphs, it might nonetheless be desirable to curb these transactions on the grounds that they unfairly provide a tax subsidy to a particular industry or a small class of taxpayers. This argument carries greater weight, however, as applied to the sub-category of these transactions that involves significant (and abusive) cross-crediting and hyped credits. It is harder to perceive an unfair tax subsidy in the case of those duplicate benefits FTC arbitrage transactions that are simply self-sheltering and where the benefit to the U.S. taxpayer is the enhanced return that it receives by way of compensation from the foreign counterparty (typically in the form of low-cost financing, an enhanced investment yield, or a payment) for the foreign tax benefits that it enjoys.

Perhaps a stronger case for interdicting these transactions (as well as possibly the reverse FTC arbitrage and U.S. withholding tax claims transactions) can be made on the grounds that, when all the hair-splitting argumentation is complete, it is simply not in the best interests of sound tax or economic policy or tax administration to permit taxpayers and their advisers to devote enormous resources to structuring these inordinately complex, tax-driven transactions. Several ancillary considerations can be advanced in support of this position.

First, the sheer complexity of many of these transactions results in the public perception that this is tax avoidance by and for rich and powerful multinationals and the financial industry. Such a general perception—especially when fueled by news reports—may have a corrosive effect on voluntary tax compliance.

Second, while public perception should not in itself justify the adoption of ill-considered measures where in fact there is no abuse under existing law or compelling policy reasons to modify the rules, at least in the context of duplicate benefits FTC arbitrage transactions, given the difficulty in determining what the alternative investment base case should be for determining whether any particular transaction or these transactions as a group in fact reduce the tax base and tax revenues (see Paragraph 7 above), Congress and the Treasury/IRS could presume that they do.

Third, the complexity of many of these transactions is, to a great extent, influenced by the need to satisfy competing tax, regulatory, accounting, legal and business considerations in the various countries and in many cases to navigate numerous technical rules and limitations under the Code and the regulations. The IRS does

not have the resources to carefully examine and to challenge taxpayers' positions on the application of these complex issues, nor to scrutinize these transactions on more general principles of substance-over-form, step transaction, economic substance, and other rules of broad general application. While many of these transactions may be prudently structured in compliance with all of these considerations, others presumably are not, and yet others presumably have at least some exposure to challenge on one or more grounds.

Accordingly, this line of reasoning would conclude, it is in the best interests of sound tax and economic policy and tax administration to curb the international tax arbitrage transactions described in Part II even if many or most of these transactions withstand scrutiny under the other policy and technical considerations discussed above.

This line of reasoning is reminiscent of some of the considerations that prompted Congress to enact the passive activity loss rules of Code Sec. 469 in order to finally close down the individual tax shelter industry.[168] There is some appeal to this line of reasoning, but on the other hand, it would seem unusual for Congress or the Treasury/IRS to interdict a class of transactions solely on the basis of this line of reasoning if in fact these transactions withstand scrutiny under other, more substantive, policy and technical considerations. Moreover, if Congress or the Treasury/IRS decide to curb complex, highly structured tax-driven transactions—whether or not they withstand scrutiny under other, more substantive policy and technical considerations—it is not clear that they should begin or end with duplicate benefits FTC arbitrage transactions (or the other transactions described in Part II), or for that matter with international tax arbitrage transactions generally.[169]

### *11. U.S. Lender and U.S. Borrower Transactions, Asset Parking, Treaty Sourcing Rules and Other Concerns*

It is worth pausing to contemplate what Commissioner Everson had in mind when he described the hyped credit financing transactions that were the subject of the second class of transactions addressed in Notice 98-5 in the following manner:

> In the case of U.S. lender transactions, a U.S. person makes a loan to a foreign person in a transaction structured to shift a portion of the borrower's foreign tax liability to the U.S. lender. In the case of U.S. borrower transactions, a U.S. person borrows from a foreign person in a manner that allows the U.S. person to pay creditable foreign taxes in lieu of deductible interest.[170]

More recently, IRS Chief Counsel Donald Korb provided the following insights into the IRS' thinking on U.S. lender transactions and U.S. borrower transactions, and added a third category of suspect transactions—asset parking transactions.[171] According to Mr. Korb:

- "In [U.S. lender transactions], a U.S. taxpayer enters into a lending transaction with a foreign company. The "baseline" transaction would be a loan by the U.S. taxpayer to the foreign company. In a traditional loan transaction, the U.S. taxpayer generally would report interest income and pay U.S. tax due on that income.
- In a typical structured transaction, the U.S. taxpayer advances the funds indirectly through a foreign special-purpose entity. Instead of receiving interest income, the U.S. taxpayer receives its investment return in the form of distributions from the special-purpose entity.
- The U.S. taxpayer also claims foreign tax credits for foreign taxes paid by the special-purpose entity. Those credits, if sustained, would eliminate the U.S. taxpayer's tax liability on its return from the financing transaction.
- In some cases, the claimed foreign tax credits are increased through additional circular flows of funds and thereby reduce U.S. tax on unrelated foreign income as well."

Mr. Korb described U.S. borrower transactions as follows:

- "The second type of case is a variation on the first. In this variation, a U.S. taxpayer is a borrower in the financing transaction. Looking once again to a "baseline" transaction, the U.S. taxpayer, as a borrower, would normally claim a deduction for interest paid to the foreign lender.
- In a typical structured transaction, the U.S. taxpayer funnels its interest payments through a foreign special-purpose entity that pays foreign taxes on that income.
- The U.S. taxpayer then claims foreign tax credits with respect to those foreign taxes. The claimed result is that deductible interest payments are converted into creditable foreign tax payments.
- In some cases, the U.S. taxpayer also attempts, through various techniques, to convert non-deductible principal payments into foreign tax credits."

Evidently, the IRS is inclined to ignore the arrangements relating to the joint investment entity (including, *e.g.,* the existence of a repo or hybrid security), the substantive U.S. tax principles that treat the U.S. participant as the owner of the investment entity or the underlying debt instruments, and the incurrence of foreign income taxes by the investment entity.[172] Instead, the IRS is proposing to view the transaction as a direct loan by the U.S. participant to the non-U.S. participant (in the case of a U.S. lender transaction) or as a direct loan by the non-U.S. participant to the U.S. participant (in the case of a U.S. borrower transaction).

As a result, according to the IRS, the U.S. lender transaction is abusive because the U.S. participant is inappropriately obtaining a foreign tax credit that really belongs to the foreign participant. The U.S. borrower transaction is abusive because the U.S. participant is paying creditable foreign taxes (through the joint investment entity) in lieu of deductible interest (to the extent the U.S. participant's interest expense is offset by its share of the joint investment entity's net interest income, to which the creditable foreign taxes relate).

I will not express a view whether Commissioner Everson's suggested characterization of these transactions is likely to be sustained under current law, especially since the details of particular transactions are not known and the basis of the IRS' analysis is not yet articulated. Nonetheless, while the analysis is very fact-specific, in general, thoughtful tax advisers have concluded that it should be possible to structure at least some of these transactions in conformity with current law.

What is of greater interest for purposes of this paper is whether as a policy matter duplicate benefits FTC arbitrage transactions in which the assets of the joint investment entity consist of debt instruments of the U.S. or non-U.S. participants (or affiliates thereof) should be curbed.

As a general proposition, in the event that Congress and the Treasury/IRS determine not to interdict duplicate benefits FTC arbitrage transactions in their entirety, it becomes difficult to articulate a convincing policy rationale for curbing U.S lender transactions since it should not make a difference from the perspective of the U.S. fisc or the U.S. participant whether the investment vehicle holds debt instruments issued by the non-U.S. participant (or its affiliates) or by third parties. In both cases, the principal issue is whether it is problematic that the U.S. participant is "voluntarily" choosing to make an investment utilizing a structure that incurs a foreign income tax,[173] and if that choice is not considered problematic where the assets are third-party debt instruments it is not evident why it should be problematic when the assets are debt instruments of the non-U.S. participant (or its affiliates).[174]

On the other hand, U.S borrower transactions raise more serious policy concerns (at least when the underlying debt instruments are not issued by a foreign affiliate) because, in essence, the U.S. participant may be viewed as generating foreign tax credits in respect of an investment in itself (or a U.S. affiliate). These concerns generally should not arise where the underlying investments are in debt or equity instruments of foreign affiliates,[175] nor where the underlying investments are receivables or other assets that were owned by the U.S. participant or its affiliates (although the latter case may raise other concerns described below).

U.S. borrower transactions may also raise policy concerns when the income of the joint investment entity from its investment in debt instruments of the U.S participant (or its U.S. affiliates) is converted into foreign source income under the terms of an income tax treaty between the United States and the country in which the investment entity is organized.[176] Similar concerns may arise when the investment entity holds debt or equity instruments of unrelated U.S. issuers, including but not limited to receivables or other assets that were owned by the U.S. participant or its affiliates. The Treasury/IRS may wish to deny the sourcing benefits of treaties in such cases on the grounds that the treaties were not intended to afford benefits in such circumstances (*i.e.,* where the treaty-eligible joint investment entity is treated for U.S. tax purposes as a tax-transparent entity that is owned entirely or in significant part by a U.S. person, so that the effect is to enable the U.S. participant to claim a foreign tax credit in respect of income that would otherwise be treated as U.S. source income that is subject to net income tax in the hands of the U.S. participant).

While denial of treaty benefits may be desirable in such circumstances, it seems pretty clear that under current law such benefits are in fact available. Indeed, Code Sec. 904(g)/904(h)[177] strongly suggests that Congress anticipated and accepted that treaties would generally recharacterize U.S. source income as foreign source income in the hands of a treaty resident in order to enable U.S. taxpayers to effectively credit foreign taxes imposed on such income by the treaty country, but limited such re-sourced income to a separate Code Sec. 904 "basket" in the limited case in which the income was earned by a foreign corporation

that is more than 50 percent owned by U.S. persons (a "U.S.-owned foreign corporation"). Thus, perhaps the way to frame the treaty concern is that Code Sec. 904(g)/904(h) does not apply to limit the recharacterized income to a separate Code Sec. 904 "basket" where the income is earned by a pass-through entity or directly by a U.S. person (rather than by a U.S.-owned foreign corporation), and that the solution is simply to expand the scope of that provision.[178]

The third category of suspect transactions that was mentioned by Mr. Korb—to which he assigned the pejorative name "asset parking transactions"—involves a subset of the case discussed above, in which the joint investment entity holds assets that were previously owned by the U.S. participant:

- "In the third type of case, a U.S. taxpayer that owns income producing assets subject only to U.S. tax transfers those assets into an ownership structure in which those assets are made subject to foreign tax.
- The U.S. taxpayer claims foreign tax credits for the foreign taxes due, thereby eliminating the U.S. tax that would it would otherwise have to pay. The new ownership structure also results in a foreign tax benefit for an unrelated foreign person who compensates the U.S. taxpayer for the benefit. Thus, the U.S. taxpayer, in effect, obtains a fee for paying foreign tax instead of U.S. tax."[179]

Asset parking transactions would be curbed if Code Sec. 904(g)/904(h) were amended as suggested above, to the extent that the underlying assets give rise to U.S. source income and the transaction relies on an income tax treaty; in addition, such an amendment would curb transactions involving assets that were not previously owned by the U.S. participant. Apparently, however, the Treasury and the IRS are viewing the problem of asset parking transactions as (i) limited to assets previously owned by the U.S. participant; (ii) possibly, including assets that generate foreign source income but that are subject to net U.S. income tax in the hands of the U.S. participant before they are transferred to the joint investment entity; and (iii) primarily raising the concern of a "voluntary" incurrence of foreign tax in lieu of U.S. tax. Presumably, the Treasury/IRS view is that prior ownership of the assets by the U.S. participant is a sufficient (and perhaps necessary) condition to establishing that the U.S. participant does not have a sufficiently weighty business reason for "voluntarily" incurring the foreign tax and therefore is presumed to have engaged in the transaction for tax avoidance reasons.

However, while asset parking transactions may appear to involve a "voluntary" incurrence of foreign tax without a sufficiently weighty business reason, basing a standard on the "voluntary" incurrence/prior ownership criterion seems to be difficult, both on conceptual grounds (for the reasons discussed above in the context of U.S. borrower transactions and in Part VI.B.6, at least in the event that Congress and the Treasury/IRS determine not to interdict duplicate benefits FTC arbitrage transactions in their entirety) and as a practical matter. For example, particularly given the fungibility of many financial instruments, is it administrable and justifiable to draw distinctions between assets that (i) were owned by the U.S. participant for some period of time, (ii) are acquired by the U.S. participant in anticipation and/or for the purpose of entering into the transaction, (iii) are receivables generated in the ordinary course of business of the U.S. participant but are assigned as of the time of origination to the joint investment entity, (iv) are acquired directly by the joint investment entity but selected by the U.S. participant, or (v) are acquired directly by the joint investment entity and selected by the foreign participant but pursuant to agreed-upon investment criteria? Moreover, as discussed in Parts VI.B.6 and VII.C.1, today—and for very good reasons—the tax law does not second-guess the business decisions of a financial institution as to how to organize its business or investment activities or the level of foreign tax that it incurs.[180] It would therefore appear preferable to address policy concerns regarding asset parking transactions through the recommended amendment to Code Sec. 904(g)/904(h) suggested above than through an effort to delineate a category of transactions that involve an unacceptable "voluntary" incurrence of foreign tax.[181]

Finally, in the course of auditing duplicate benefits FTC arbitrage transactions the IRS may become aware of patterns of other transaction features that are troublesome and should be curbed. For example, in certain circumstances the terms of various components of such transactions (such as financial instruments, swaps or other arrangements between the participants and their affiliates), viewed separately and/or in the aggregate, could raise concerns regarding, *e.g.,* economic substance, step transaction, arm's-length pricing or the application of various technical rules.

### *12. Summary*

While the foregoing discussion illuminates the relevant policy considerations for evaluating duplicate benefits FTC arbitrage transactions, to my mind it does not provide a clear or definitive answer as to whether those transactions are sufficiently problematic as a tax policy matter that they should be curbed in their entirety.

Putting aside the fairness, perception of abuse and tax administration considerations discussed in Paragraph 10 above, it appears that the principal policy considerations favoring a general curb on duplicate benefits FTC transactions are that the taxpayer has voluntarily and deliberately chosen to structure its investment through an entity and/or in a manner that is subject to foreign income tax, where it just as well could have invested in a manner that avoided the foreign tax, and that the consequent erosion of the U.S. tax base should not be countenanced. However, as discussed in Paragraphs 6 and 7 above, it is far from clear that these considerations are necessarily accurate or sufficiently weighty to justify a general curb on these transactions.

Nonetheless, Congress or the Treasury/IRS could reasonably determine that such transactions should be curbed in their entirety, taking account also of the fairness, perception of abuse and tax administration considerations discussed in Paragraph 10 above. For similar reasons, Congress or the Treasury/IRS might reasonably determine that reverse FTC arbitrage and U.S. withholding tax claims transactions should also be curbed.

A somewhat stronger case can be made for curbing those duplicate benefits FTC transactions in which there is cross-crediting and hyped credits, although it would seem appropriate to curb only those transactions in which the amount of cross-crediting is substantial and abusive (as appropriately defined). In addition, there is a potential tension between curbing such transactions and the Code Sec. 904 limitation, which represents a detailed set of rules, carefully considered by Congress, as to the degree of cross-crediting that is permitted. Indeed, the 2004 Act's reduction in the number of baskets from eight to two, effective beginning 2007, seems at least facially to adopt a policy stance in favor of easing, rather than enhancing, the limitations on cross-crediting. Any curbs on duplicate benefits FTC arbitrage transactions involving cross-crediting would need to be reconciled both with the policy thrust of the Code Sec. 904 limitation and with its technical rules. Moreover, given the statutory approach to cross-crediting that is embodied in the Code Sec. 904 limitation, in the absence of Congressional action to curb hyped credit transactions or the grant of regulatory authority to the Treasury and the IRS to do so, the Treasury and the IRS would need to consider the extent of their authority to issue any particular guidance curbing such transactions.[182]

In any event, the implementation considerations discussed in Part VII below will be important in developing standards for distinguishing between "good" and "bad" transactions.

Finally, it would appear appropriate to curb duplicate benefits FTC transactions where the investment entity holds debt instruments of the U.S. participant or its U.S. affiliates (*i.e.*, U.S. borrower transactions) and to expand the scope of Code Sec. 904(g)/904(h) (which should address asset parking transactions as well as other cases where the assets held by the joint investment entity are instruments of U.S. issuers), and it may be appropriate to curb transactions involving certain other specific features that the IRS considers to be problematic. On the other hand, there does not appear to be a strong policy rationale for generally curbing transactions where the investment entity holds debt instruments of the non-U.S. participant or its affiliates (*i.e.*, U.S. lender transactions).

# VII. Possible Approaches to Addressing FTC-Related Arbitrage Transactions and Relevant Implementation Considerations

## A. The Technical Taxpayer Rule vs. the Matching Principle in the Context of FTC Separation Structures

As discussed in Part IV, Paragraph 3, above, the proposed revisions to Reg. §1.901-2(f) should effectively prevent the separation of foreign tax credits from the related income in the consolidated tax regime and reverse hybrid situations described in Part II.A above. As summarized above, the proposed regulations would amend and clarify the technical taxpayer rule by providing that, "[i]n general, foreign law is considered to impose legal liability for tax on income on the person who is required to take the income into account for foreign income tax purposes,"[183] and would make certain other changes to the regulations. Essentially, the proposed regulations (i) retain the technical taxpayer rule; (ii) limit its application to those situations in which a debt instrument is transferred in the middle of an interest period and the interest is paid subject to a withholding tax (and presumably similar situations involving accrued rents and royalties)[184]; and (iii) adopt a limited matching rule that provides for a matching of the foreign tax and the income in the person that is required to take the income into account for foreign tax purposes.

Part IV, Paragraph 3, above, criticizes the proposed regulations for not attributing the foreign tax and the

related income, on a matched basis, to the person that has "paid" the foreign tax in accordance with U.S. tax principles (but instead applies foreign tax principles), and explains why the proposed regulations reach inappropriate results in many common situations involving nominee, agency and repo arrangements. This Part VII.A considers whether the matching principle should be extended to all situations covered by the technical taxpayer rule and conversely, whether it is a mistake to curtail the technical taxpayer rule to the extent provided in the proposed regulations.

The technical taxpayer rule is a long-standing rule of administrative convenience, which benefits both taxpayers and the IRS. It provides a simple, straightforward guideline for determining which person is entitled to claim a foreign tax credit. As originally formulated, it minimizes fraudulent, duplicate and unsubstantiated claims because the person on whom the foreign tax is imposed should be in the best position to establish that the tax was indeed paid and to produce a receipt therefor. However, this rule of administrative convenience should not stand in the way of efforts to interdict transactions and structures that separate credits from the related income in a manner that is abusive and inconsistent with substantive tax policies. Accordingly, the proposed regulations appropriately limit the scope of the technical taxpayer rule in order to combat FTC separation structures.

Moreover, it would seem that whatever administrative benefits the technical taxpayer rule might have once provided in terms of ease of proof of entitlement to tax credits, alternative mechanisms for proving entitlement to tax credits are readily available where substantive tax policies dictate that someone other than the person on whom foreign law imposes legal liability for the tax should be entitled to the credits. For example, in the same way that mechanisms exist for a partner that is allocated creditable foreign taxes of a partnership, or a 10-percent corporate shareholder that claims an indirect foreign tax credit for taxes paid by a corporation from which it receives a dividend, or a bondholder that claimed a credit for withholding taxes in the Brazilian withholding tax cases,[185] to establish its entitlement to the credit, so too it should be possible to establish entitlement to the credit in other cases in which the technical taxpayer rule is overridden. Especially in the case of FTC separation structures, which generally involve related persons, this should not be a problem.

On balance, the technical taxpayer rule should continue to apply in the context of withholding taxes on payments of interest, dividends, rent, royalties, *etc.* where there has been a transfer of the underlying property in the middle of the accrual period, and should not be replaced with a matching rule. Congress has specifically addressed perceived abuses in this context through the enactment of Code Secs. 901(k) and (l). While an argument can be made that a matching rule would achieve economically more accurate results and would not be inconsistent with Code Secs. 901(k) and (l), given Congress' enactment of these provisions and the fact that the technical taxpayer rule does provide administrative benefits in the case of stock and securities that are traded in the capital markets, it appears that the proposed regulations reach the right result in having the technical taxpayer rule continue to apply in these situations.[186]

## B. Broad Anti-Abuse Approaches to Duplicate Benefits FTC Arbitrage Transactions

Determining what is an appropriate approach to particular categories of FTC arbitrage transactions (or to international arbitrage transactions in general) depends to a great extent on one's view as to what, if anything, is the problem presented by such transactions. Crafting and implementing an approach to such transactions will also be influenced by the implementation and administrability considerations discussed in Part V, Paragraph 6, above, including (i) whether under the circumstances it is preferable to adopt a broad, general anti-abuse rule or a specific, targeted technical rule; and (ii) whether the approach should be a unilateral U.S. response or a bilateral or multilateral approach.

This Part VII.B discusses several broad anti-abuse approaches that Congress, the Treasury and the IRS might consider in the event they determine that duplicate benefits FTC arbitrage transactions (or certain other international arbitrage transactions) are problematic in general and should be interdicted in their entirety. Part VII.C discusses more specific approaches, based on various existing foreign tax credit rules, for curbing duplicate benefits FTC arbitrage transactions in their entirety. Parts VII.D and E discuss approaches (including the "enhanced economic profit test" of Notice 98-5) for curbing only those transactions that involve improper cross-crediting. Subsequent portions of this Part VII consider other implementation-related considerations. Part VII.J summarizes the principal possible approaches and discusses regulatory authority issues that they present.

### *1. General FTC Anti-Abuse Rule*

Perhaps the most sweeping approach would be to promulgate a general anti-abuse statute or regulation, patterned after the partnership anti-abuse rule.[187] The provision would contain (i) a statement of the intention and objectives of the foreign tax credit, (ii) a depiction of the basic criteria and conditions for claiming a credit, (iii) examples of transactions that satisfy and that fail to satisfy the relevant policies and conditions, and (iv) a grant of authority to the IRS to disallow the credit in circumstances in which the relevant policies and conditions are violated.

There is a range of views regarding the appropriateness and efficacy of general anti-abuse rules. On the one hand, such a rule can serve as an important backstop to technical rules that are targeted at specific, known abuses, so as to discourage taxpayers and their creative tax advisors from constantly circumventing the literal provisions of the Code and regulations. On the other hand, depending on the context and formulation of such a rule, the rule may be criticized for being too vague and thereby failing to fairly apprise taxpayers and IRS agents of the parameters of permitted and proscribed transactions and structures. As a result, the rule might have an undesirable chilling effect on legitimate business activities or might be dismissed by some taxpayers on the grounds that its over-breadth and vagueness make it irrelevant in practice.[188]

These considerations are relevant in evaluating whether a general FTC anti-abuse rule might be appropriate and efficacious. Additionally, if such a rule were adopted, it is important that the Treasury and the IRS clearly explain the interplay between the scope of that rule and the intricate web of rules—described in Part IV above—that already prescribe the scope of the foreign tax credit. Nonetheless, it would appear that such a rule might well serve a useful function provided that (i) it is coupled with more precise anti-abuse rules that address specific identified transactions and structures that are of concern to the Treasury and the IRS, so that it serves as a backstop rather than the principal demarcation between acceptable and proscribed activities; (ii) it clearly articulates the policies and considerations that are relevant to ascertaining the circumstances in which a credit is and is not available (including by reference to the already elaborate scheme of provisions governing the availability of the credit, as described in Part IV); and (iii) it contains informative examples from which taxpayers and IRS agents can derive practical guidance. It remains to be seen whether such a general anti-abuse rule can be crafted effectively.

### *2. Foreign Conformity Rule*

One group of approaches that is discussed in the literature is a "general soak-up" rule, under which the U.S. taxpayer would be required to conform the U.S. tax treatment to the foreign tax treatment (regardless of what that might be, and without any specific direction) or, under a "modified soak-up" rule, would be required to follow the specific treatment prescribed by the IRS.[189] These approaches would appear to implement fully the "single tax principle" discussed in Part V by ensuring that income from cross-border transactions is taxed once (not more, but not less). However, apart from the serious shortcomings of these approaches that have been identified elsewhere,[190] these approaches can be criticized for abdicating responsibility for determining the U.S. tax consequences of a transaction to the foreign tax authorities. Thus, for example, if the U.S. conception of a repo transaction as constituting a financing for U.S. tax purposes is considered to properly reflect U.S. tax principles, it appears difficult to justify a departure from that treatment merely because another party to the transaction is subject to a foreign tax rule that treats it (as the party that repoed in the security) as the owner for foreign tax purposes. Accordingly, it would be ill-advised to go down this path.

### *3. Expanded DCL Approach*

Another approach that would broadly interdict duplicate benefits FTC arbitrage transactions would be, essentially, to expand the DCL framework so as to cover not only losses but also foreign tax credits. In general, under this approach, a foreign tax credit would be disallowed if and to the extent that the foreign tax that gives rise to the credit can be utilized to offset the foreign income tax liability of another foreign corporation.

Such an approach would raise a number of significant definitional and scope issues. It would be necessary to delineate what sort of foreign utilization is encompassed within the rule—foreign tax credit, imputation credit, exclusion of the related income, dividends received deduction, manufactured dividends benefits, *etc.* It would also be necessary to specify the circumstances and level of actual or potential utilization that results in a disallowance of the foreign tax credit. Indeed, whereas the DCL rules impose an onerous burden on taxpayers to establish that the loss can never be utilized under any circumstance, it may be appropriate to adopt a less draconian approach if this framework were to be expanded to cover foreign tax credits.[191]

Given the variety of ways in which foreign tax systems operate and the challenges of coordinating between those tax systems and the U.S. tax rules, an approach that is based on an expansion of the DCL rules is likely to involve an extraordinarily complicated set of rules that will impose significant compliance burdens on virtually every taxpayer claiming foreign tax credits (regardless of whether the taxpayer has knowingly engaged in a FTC arbitrage transaction) and may well result in serious overinclusive and underinclusive consequences (as evidenced by the existing DCL rules). Such an approach is not recommended.

If the foregoing problems of an expanded DCL approach could be overcome, it might be productive to use as a model the "G-1 election" that was put in place under the recently completed U.K.-U.S. DCL Competent Authority Agreement,[192] so that the U.S. and foreign participants in a duplicate benefits FTC arbitrage transaction would be permitted or required to enter into a joint election to claim the benefits in one country or the other (but not in both). However, such a joint election would likely be more complicated than the DCL G-1 election because the participants in a duplicate benefits FTC arbitrage transaction are typically unrelated to one another and economically would reasonably expect to be able to divide (but not duplicate) the tax benefits, and the tax benefits in each country are not necessarily equivalent in nature.[193]

## C. Approaches to Duplicate Benefits FTC Arbitrage Transactions That Are Based on the Existing FTC Rules

As indicated in Part IV above, several recent pronouncements by the IRS suggest that the IRS might be considering interpreting or expanding existing provisions under the foreign tax credit rules in a manner that would curb duplicate benefits FTC arbitrage transactions. This Part VII.C considers possible approaches that are based on the (i) noncompulsory payment, (ii) subsidy, (iii) technical taxpayer and (iv) Code Sec. 904 "basket" rules. For the reasons discussed below, I believe that the first three approaches are not likely to yield a productive course of action for addressing duplicate benefits FTC transactions. A common concern with each of these approaches is that the relevant rules are designed to address particular concerns, having very little or nothing to do with duplicate benefits FTC transactions, and their adaptation or extension to cover such transactions appears to miss the nature and relevant considerations of those transactions. The last approach would appear to be workable in the event Congress were to determine that all duplicate benefits FTC arbitrage transactions should be curbed, although its implementation would raise some complexities.

### *1. Noncompulsory Payment Rule*

As discussed in Part IV, Paragraph 1, and Part VI.B.6 above, insofar as duplicate benefits FTC arbitrage transactions may involve a deliberate choice to invest in passive assets through a foreign entity or through a particular manner of operation and thereby to incur a foreign tax, it may reasonably be asked whether the foreign tax might be disallowed on the grounds that it is a noncompulsory payment, either under the existing regulations or under an approach that would expand the definition of noncompulsory payment to cover such transactions.

It seems obvious that, as presently drafted, the noncompulsory payment rule does not disallow a foreign tax credit in a conventional duplicate benefits FTC transaction. The noncompulsory payment rule clearly focuses on decisions made by the taxpayer in respect of the actual payment of a foreign tax and the handling of administrative procedures for recovering, abating or claiming a refund or exemption from the tax.[194] It affirmatively disavows any intention to question decisions made by the taxpayer as to how to organize its business or investment activities: "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 liability under foreign law for tax."[195]

Thus, the question is whether the noncompulsory payment concept should be revised and expanded to cover a decision to invest in passive assets through a foreign entity or through a particular manner of operation and thereby to incur a foreign tax. In Part VI.B.6 above, I discuss some of the conceptual and practical issues that are raised in seeking to define the problem of duplicate benefits FTC arbitrage transactions by reference to whether the foreign tax payment is compulsory or voluntary. Similar issues exist in seeking to implement an operative rule that would distinguish between "good" and "bad" transactions based on such a distinction. Essentially, as discussed above, it is often quite difficult to conclude that the selection of a particular form of entity or manner of operation—which results in the imposition of a foreign tax—is so lacking in nontax motivation or benefit that it should be proscribed, and the criteria for distinguishing between "good" and "bad" transactions on that basis are elusive.

Moreover, the noncompulsory payment rule appears to be concerned with ensuring that a taxpayer has an appropriate economic incentive to contest improper impositions of foreign tax so that the U.S. government is not prejudiced, or in the words of one commentator, the "moral hazard" problem.[196] The formulation of the noncompulsory payment rule in the regulation is tailored to meet those concerns, and it appears to be ill-suited to provide useful guidance in determining whether a duplicate benefits FTC transaction structure involves a "voluntary" foreign tax payment.

Finally, the tax law generally takes a benign view of decisions by taxpayers regarding the form and manner in which to organize and conduct their business and investment activities,[197] notwithstanding that these decisions can have significantly different tax consequences and may largely be driven by tax considerations. Instead of seeking to prescribe objective tests or criteria for distinguishing between acceptable and bad decisions of that nature, the tax law generally gives taxpayers the latitude to structure their business and investment activities as they see fit, and relies on general principles such as the business purpose, economic substance and step transaction doctrines to police aggressive behavior. The statement in the compulsory payment regulation to the effect 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 liability under foreign law for tax"[198] is entirely consistent with, and presumably is animated by the same considerations as, this broader "hands off" attitude towards such business, operational and tax planning.



### *2. Subsidy Rule*

It has been suggested from time to time that the "subsidy" rule, as presently formulated or as it might be revised, should serve as a basis for disallowing foreign tax credits in duplicate benefits FTC arbitrage transactions. Under the subsidy rule, a tax is not a creditable foreign income tax to the extent that:

> (1) the amount such tax is used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means to the taxpayer, a related person (within the meaning of Code Sec. 482), or any party to the transaction or to a related transaction, and (2) such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax.[199]

It has been suggested that when a non-U.S. participant in a duplicate benefits FTC arbitrage transaction benefits from a credit, exclusion or other mechanism that relieves it from paying foreign tax in respect of its share of the joint venture entity's income, it has derived a subsidy, or a benefit akin to a subsidy.

In the typical duplicate benefits FTC arbitrage transaction, the foreign country has an integrated tax system or imputation system that eliminates a shareholder level tax in respect of earnings that have been taxed at the level of the lower entity, *via* a credit, deduction, exclusion or other mechanism. These systems are not dissimilar to the 100-percent dividends received deduction or consolidated tax return rules in the United States, and reflect a tax policy common to many developed countries of reducing or eliminating multiple levels of taxation in respect of corporate earnings.

Although the definition of "subsidy" in the regulations does not explicitly state that credits or other benefits under an imputation or integrated tax system are not a "subsidy" for purposes of Code Sec. 901(i) and the regulations thereunder,[200] it seems evident that indeed such credits and other benefits are not a "subsidy" under current law. The legislative history of Code Sec. 901(i) indicates that the main purpose of the subsidy rule is to prevent the Treasury from bearing the cost of programs instituted by foreign countries that *effectively rebate or refund* some or all of a tax with respect to which a U.S. foreign tax credit is being claimed by conferring a benefit determined by reference to that tax:

> The committee does not believe that foreign tax credits should be allowed for foreign taxes which, *while ostensibly imposed, are effectively rebated* by the levying country by means of a government subsidy to the taxpayer, a related party, or a party to a transaction with the taxpayer. To eliminate any uncertainty in this area, the committee believes that the Treasury regulation disallowing foreign tax credits for taxes used as a subsidy to the taxpayer should be codified.[201]

Cases, IRS rulings and the examples in the regulation are all consistent with the view that the subsidy rule is aimed at situations in which a foreign country *effectively rebates or refunds* some or all of the foreign tax with respect to which a credit is being claimed.[202] Consequently, the IRS has indicated that traditional imputation systems do not *per se* create a subsidy issue. For example, in a field service advice memorandum discussing the German imputation system, the IRS noted

that "[i]ntegrated systems are unique and cannot be analyzed under the existing § 901 regulations dealing with refunds or subsidies."[203] Similarly, the Tax Court has held that the United Kingdom's former advance corporation tax (ACT) integration system did not give rise to an impermissible subsidy when the U.K. parent surrendered to its subsidiaries its right to offset its mainstream corporate tax by the amount of ACT that it paid when it distributed a dividend to its U.S. shareholder.[204]

If the question is modified to be whether the subsidy rule can or should be expanded so that it can be employed as a tool to disallow foreign tax credits in duplicate benefits FTC arbitrage transactions, I would answer in the negative. Surely, it would be a surprising and profoundly unwise step to expand the meaning of "subsidy" to cover every situation in which a foreign country allows an imputation credit or other integrated or consolidated tax regime benefit to a related person or another party to a transaction, as a result of the payment of a foreign tax. The subsidy rules themselves do not currently distinguish between various situations in which the "subsidy" is granted and do not draw distinctions based on the relationship between the recipient of the subsidy and the U.S. taxpayer, nor do they need to do so.[205] If such distinctions were to be drawn so as to limit the effect of the subsidy rule to "bad" transactions but leave "routine" applications of integrated tax regimes unaffected, it would be necessary to address definitional and scope issues similar to those adverted to in Part VII.B.3 above in the context of an expanded DCL approach. In any event, such details would be extraneous to the core subsidy rule, so it is questionable why a "fix" to the duplicate benefits FTC arbitrage transactions problem should be grafted onto the subsidy rule.

### *3. Technical Taxpayer Rule*

As mentioned in Part IV, Paragraph 3 above, Example 3 in proposed Reg. §1.901-2(f) concludes that the taxpayer, which repoed out a bond and is treated as beneficial owner of the bond under U.S. tax principles, is not eligible to claim a credit for the foreign withholding tax because the foreign country treats the party that repoed in the bond (and holds legal title thereto) as the owner for tax purposes. A recent chief counsel advice reached a similar result.[206]

If the technical taxpayer rule is interpreted in the foregoing manner, it should prevent duplicate benefits FTC transactions involving withholding taxes, at least in those limited cases in which there is a direct repo of the stock or debt security in respect of which the withholding tax is imposed. This would be ineffectual, however, because under the proposed regulation it would not apply where the stock or security is held through a disregarded entity that in turn was the subject of the repo.[207] Moreover, this approach would not apply to duplicate benefits FTC arbitrage transactions that involve entity-level taxes.

Furthermore, and of greater concern, as discussed in Part IV, Paragraph 3, above, this approach is inconsistent with commercial and capital markets practices and existing law. It will impose an unnecessary and unwelcome burden upon taxpayers and the IRS in many commercial situations to determine whether the tax law of a particular country treats the U.S. taxpayer as the taxpayer under a particular repo, nominee or agency arrangement. Additionally, this approach departs from the principle of looking to foreign law only to ascertain the relevant facts, but to U.S. tax principles to determine who is the relevant taxpayer.[208]

Thus, the technical taxpayer rule is a poor device for implementing a curb on duplicate benefits FTC arbitrage transactions.

### *4. Code Sec. 904 "Basket" Rule*

Congress could curb duplicate benefits FTC arbitrage transactions by creating a new Code Sec. 904 limitation category (or "basket") for income from such transactions. Under this approach, credits from such transactions would be available to offset only income from such transactions. The limitation could be applied either on a transaction-by-transaction basis or by aggregating all such transactions in one basket.[209]

The duplicate benefits FTC arbitrage transactions that are covered by this rule could be defined by reference to the criteria set forth in Part II.B above. In order not to adversely affect common repo financing transactions or nominee arrangements similar to those described in Examples 2 and 3 of proposed Reg. §1.901-2(f)(6), consideration might be given to excluding such transactions unless the taxpayer has reason to believe that a non-U.S. participant is claiming foreign tax benefits associated with ownership of the property.

This approach presents some degree of complexity in terms of calculating the income from the transaction that is subject to the limitation, similar to the issues discussed in Part VII.D below (in the context of an approach that targets cross-crediting) in respect of the attribution of items of income, interest and other expenses to the transaction. However, these issues are generally comparable to the similar calculation issues that are routinely presented in respect of the other Code

Sec. 904 limitation categories. These issues appear easier to address in practice in the context of a separate Code Sec. 904 "basket" approach than in the context of a test (such as the approach discussed in Part VII.D below) that seeks to define the problematic cases by reference to the degree of cross-crediting that is involved, since unlike those cases, it would not be necessary to quantify the extent of the cross-crediting.

## D. Approaches to Duplicate Benefits FTC Arbitrage Transactions That Disallow Benefits Where There Is Improper Cross-Crediting

In the event that Congress or the Treasury/IRS conclude that duplicate benefits FTC arbitrage transactions are not *per se* problematic as a class but that those transactions in which there is cross-crediting (either at all or above a certain level)—should be curbed, it will be necessary to devise a rule that (i) clearly delineates between the "good" and "bad" transactions and (ii) prescribes the consequences of a "bad" transaction.[210] The challenges in devising such a rule are formidable.

In the case of cross-crediting, a delineation between the "good" and "bad" transactions and quantification of the extent of any cross-crediting require that there be clear, workable and sensible rules for determining the amount of income and of interest and other expenses that are attributable to the transaction, so that an accurate determination can be made whether and by what amount the effective foreign tax rate on the net taxable income from the transaction (as determined for U.S. income tax purposes) exceeds the U.S. tax rate. The presence of a high effective foreign tax rate would indicate that the transaction is generating excess foreign tax credits that may be utilized to offset U.S. tax on other income in the same foreign tax credit "basket."

As noted above, the Code Sec. 904 limitation in effect represents Congress' judgment as to the degree of cross-crediting that is permissible in the foreign tax credit context. If Congress or the Treasury/IRS concludes that an additional restriction on cross-crediting is appropriate, it would generally seem desirable—in the absence of a strong reason to do otherwise—to utilize a similar rule for attributing interest and other expenses for purposes of both limitations. Such conformity would seem appropriate given the similar objectives of both limitations, the common policy issue presented by the expense attribution question in both contexts, and the high compliance cost of applying two different sets of undoubtedly complex rules.

In general, for purposes of the Code Sec. 904 limitation, interest expense is allocated pursuant to Code Sec. 864(e) and the regulations under Code Sec. 861 in accordance with a fungibility principle, so that the relevant taxpayer group's worldwide interest expense is allocated based on the relative (adjusted tax book or fair market) values of the assets in the relevant (U.S. and foreign) groupings.[211] Applying a fungibility principle prevents a taxpayer from disproportionately underleveraging a particular activity with a view to overstating its profitability (or, for purposes of the Code Sec. 904 limitation, understating the effective foreign tax rate on the income generated therefrom). However, a fungibility approach also enables a taxpayer that enters into a structured transaction that is more highly leveraged than its general leverage ratio or that has a higher interest rate to reduce for tax purposes the leverage and interest expense attributable to the structured transaction.

Nonetheless, when the Treasury and the IRS considered the interest attribution issue in Notice 98-5, they concluded that a tracing concept should serve as the general rule for attributing interest expense to a duplicate benefits FTC arbitrage transaction.[212] As the foregoing discussion indicates, whether a tracing approach is more or less likely than a fungibility approach to result in an adverse characterization of a transaction will depend on the particular circumstances. However, perhaps the Treasury and the IRS felt that a tracing approach was more appropriate for the enhanced economic profit test of Notice 98-5 because where the focus is on the non-tax economic profit of a particular transaction it is proper to treat the transaction on a stand-alone basis and take into account only the incremental items of expense attributable to the transaction. The Treasury and the IRS may also have believed that a fungibility approach would not curb a sufficient number of "bad" transactions because it already serves as a filter for the Code Sec. 904 limitation, and that it would not add enough "bite" simply to utilize essentially the same calculation on a separate transaction basis.

In any event, a tracing approach introduces an additional set of complex issues relating to the standard (and the ordering rules) to be applied to determine the degree of causality and nexus necessary to trace liabilities and expenses to a transaction. Moreover, a tracing approach will likely make it very difficult to distinguish between transactions that are acknowledged to be "bad" and many other commercial transactions involving leveraged acquisitions of foreign stock and securities that generally are considered to be benign.

Furthermore, a tracing approach can often be circumvented by infusing equity capital (or funds attributable to general borrowings) in a particular transaction.[213]

In addition to prescribing rules for determining the amount of interest and other expenses attributable to the transaction, it will be necessary to determine the scope of the transaction and, hence, the amount of income (and related expenses) that should be taken into account.[214] Notice 98-5 presented a window into some of the issues that would need to be addressed in this regard, such as the treatment of various financial contracts (*e.g.,* swaps),[215] but did not provide useful guidance as to how to resolve the difficult scope delineation questions that might arise.[216] Similarly, the treatment of various types of base and timing differences between U.S. and foreign tax law concepts of income would need to be addressed.

More fundamentally, as previously noted, an approach that tags certain transactions that involve cross-crediting as "bad" transactions is at a basic level inconsistent with the Code Sec. 904 limitation, which permits cross-crediting within broad baskets. The rationale behind the Code Sec. 904 limitation's basket approach is, very generally, that some level of cross-crediting is acceptable as a tax policy matter because of the integrated nature of U.S. multinational operations abroad, and therefore cross-crediting should not be objectionable as long as it is within prescribed baskets that separate active business income from other categories of income (that are potentially more mobile and manipulable).[217] Putting aside the broader policy questions discussed in Part VI.B above—including, of particular relevance, the policy considerations relating to the interplay between the foreign tax credit and the commercial imperative of highly leveraged investments in financial assets by financial institutions (and the practical implementation challenges with respect thereto)[218]—if a decision is made to test separately some or all transactions that involve cross-crediting, consideration needs to be given to whether the distinction between "good" and "bad" transactions will be made solely on the basis of the relative or absolute amount of cross-crediting that is taking place (and if so, how and where to quantify the tipping point), or whether other criteria—including whether the transaction involves a duplicate benefits FTC arbitrage structure altogether—should also play a role.

Thus, for example, will the "bad" category apply only to a duplicate benefits FTC arbitrage transaction in which the effective foreign tax rate (as applied against income as determined for U.S. tax purposes) is above, say, 90 percent? Will it apply to any leveraged acquisition of a stock or security (*e.g.,* a standard repo financing) that pays a coupon that is subject to a high withholding tax, even where the relevant holding period under Code Sec. 901(k) or (l) is met? And will it apply to a situation in which a U.S. taxpayer acquires a foreign target corporation and significantly reduces its future earnings and profits (and taxable income) for U.S. tax purposes by making a Code Sec. 338(g) election and generating significant depreciation and amortization deductions for U.S. tax purposes, so that the effective foreign tax rate is above, say, 90 percent?[219] Needless to say, even if a policy decision were made to have the test apply to transactions other than duplicate benefits FTC arbitrage transactions (a position that I do not advocate), it would be highly desirable if any approach that might be adopted in respect of hyped credit transactions did not require taxpayers engaged in normal business or investment activities and customary tax planning to have to apply complicated tests to discrete transactions or activities to determine whether any foreign tax credits are subject to disallowance and to have the IRS audit these complicated tests.

Regardless of whether or not an additional curb on cross-crediting (beyond the existing Code Sec. 904 limitation) is limited to duplicate benefits FTC arbitrage transactions, it will be necessary to prescribe the level of cross-crediting that triggers the new limitation. Especially given the complexities of the definitional issues regarding scope and the attribution of items of income and expense to the transaction, as well as the general tolerance of a degree of cross-crediting under the Code Sec. 904 limitation, it would appear that the trigger should be set at a level at which there is a significant amount of cross-crediting. Indeed, the enhanced economic profit test under Notice 98-5, discussed in Part VII.E below, which in effect was designed to curb duplicate benefits FTC arbitrage transactions involving cross-crediting, eschewed a low trigger in favor of the expected economic profit being "insubstantial" relative to the foreign tax credits. Consistent with this view, the example given above suggested a trigger of a 90 percent effective tax rate (*i.e.*, slightly less than three times the U.S. federal tax rate). However, it is not clear that either this approach to quantifying cross-crediting or the level of the trigger is appropriate.

Finally, it should be recognized that selecting a level of cross-crediting at which a FTC arbitrage transaction becomes "bad" and prescribing the consequences thereof involve a degree of rule-making that, in the absence of a clearer Congressional authorization and

in light of the existing legislative framework of the Code Sec. 904 limitation, may be open to challenge as being beyond the regulatory authority granted to Treasury and the IRS. The regulatory authority issue is discussed further in Part VII.J below.

## E. The Enhanced Economic Profit Test of Notice 98-5, Treating Foreign Taxes As an Expense

Notice 98-5 represented the first (aborted) effort of the Treasury and the IRS to articulate a test for identifying and curbing those duplicate benefits FTC arbitrage transactions involving cross-crediting that were considered abusive. As noted above, the enhanced economic profit test announced in Notice 98-5 (and abandoned in Notice 2004-19) considered such transactions abusive where the expected economic profit was "insubstantial" relative to the foreign tax credits. While the Notice did not specify a "bright-line" substantiality level, in the various examples contained in the Notice, the taxpayer either expected a loss or a profit that was three, eight or 12 percent of the tax credits, as determined under the special profit test of the Notice. Based on these examples, tax advisers generally believe that an economic profit of 25 percent to 30 percent of the credit should suffice under the Notice.

Notice 98-5 prescribed rules for determining the economic profit for this purpose, including the special rules described in Part VII.D above for delineating the scope of the transaction and attributing interest expense and other items of income and expense to the transaction. The Notice also stated that for purposes of applying its profitability test, foreign taxes should be treated as an expense. This treatment of foreign taxes has reappeared in the Senate's proposal to codify the economic substance doctrine.[220]

Notice 98-5 has been criticized on a number of cogent grounds,[221] and the Treasury and the IRS eventually withdrew the Notice because they "do not intend to issue regulations in the form described in Notice 98-5," but without providing further explanation.[222]

This Part VII.E considers the suitability of an economic substance test for evaluating FTC arbitrage transactions generally and the proposition that foreign taxes should be considered an expense for purposes of such a test.

In general, the economic substance test is a judicial doctrine that denies tax benefits where the transaction that gives rise to those benefits lacks economic substance independent of tax considerations. "The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings."[223] The economic substance test is traditionally viewed as looking at whether the transaction serves an objective economic purpose, ignoring tax consequences. In other words, excluding tax consequences, is the taxpayer exposed to economic risk, does it have a realistic possibility of earning a meaningful (pre-tax) profit, and/or does the transaction have another practical economic justification apart from the tax benefits?[224]

From one perspective, it seems natural to consider the economic substance test a proper and appropriate tool to evaluate whether a hyped credit FTC transaction is abusive, because in an extreme case there might be little or no economic profit but a significant tax benefit in the form of a foreign tax credit. There are several significant hurdles, however, to effectively applying the economic substance test to evaluating hyped credit FTC transactions. Other commentators have already noted that the test can be manipulated (*e.g.,* by funding the transaction with less directly traceable debt) and therefore does not adequately distinguish between "bad" and "good" transactions.[225] Also, the test "does not accurately gauge when a taxpayer is bearing the burden of taxes and when he is entering into a transaction that makes no sense in the absence of taxes."[226] To the extent it identifies transactions in which there is a high effective foreign tax rate, the test will sweep in many non-abusive, business-motivated transactions in the absence of an additional filter.[227]

One commentator summarized his thoughtful and comprehensive analysis of the Notice as follows:

> Notice 98-5 might best be understood as a step taken by Treasury to revise the current basket system by adopting, in effect, a high-tax kickout rule for individual transactions involving withholding taxes and tax arbitrage. Plainly, the IRS could not have simply issued a press release announcing new limitation baskets under section 904. Instead, they announced that an economic profit test applies to foreign tax credits, but only in two areas. The notice's economic profit test is derived from the common law economic substance test that applies in other settings, but that test as formulated in the notice loses its bearings when applied to foreign tax credits. It does not properly draw the line between abusive and nonabusive transac-

tions, is more likely to deny credits where taxes are not borne economically by a taxpayer than where they are, and in light of section 904, cannot reasonably be justified as a step required to fill in gaps in the statutory articulation of congressional intent. Indeed, in many respects, the test conflicts with section 904. It may be a fair reading of the notice that Treasury decided on policy grounds to deny credits for withholding taxes and in tax arbitrage transactions, and invoked the economic profit test incidentally, as a way of shoring up the legal support for the actions taken.[228]

In addition to the foregoing problems, the economic substance doctrine typically focuses on pre-tax cash flows,[229] and is most commonly applied to test transactions in which the tax benefits are deductions or losses of one sort or another that may or may not involve current cash outlays and often involve timing benefits rather than a real economic loss.[230] A foreign tax credit is, of course, different. Although a foreign tax credit involves an actual cash expenditure, the expenditure is a substitute for (and an offset against) a U.S. income tax liability and therefore is equivalent to an offsetting receipt of cash, or a nonevent as a pre-tax matter. As a result, one must ask whether, for purposes of applying the economic substance doctrine, the foreign tax credit should be viewed as a pre-tax expenditure or as equivalent to a U.S. income tax liability.

If a creditable foreign tax is never treated as an expenditure but instead is viewed as a substitute for the equivalent amount of U.S. tax that would otherwise be paid, the economic substance doctrine would have virtually no practical application for testing foreign tax credits, since the pre-U.S. income tax economic profit with and without payment of the foreign tax would be the same.

On the other hand, treating a creditable foreign tax as a pre-tax expense in applying the economic substance test, rather than as a surrogate for the U.S. income tax that it offsets, would seem to be inconsistent with the objective of the foreign tax credit (and the essence of its being a credit rather than a deduction), as well as with the principle of capital export neutrality, because it would discriminate against foreign investments. As noted in Part VI.B.6 above, it is reasonable for Congress or the Treasury/IRS to conclude as a policy matter that neutrality (or equivalence) between payment of foreign and U.S. income taxes should be tempered where there are countervailing considerations, but a rule that always treats foreign taxes as an expense for purposes of applying the economic substance doctrine is certain to have an impact beyond the problematic cases in which those countervailing considerations should have sway.[231]

Nonetheless, Notice 98-5 and the Senate's proposed codification of the economic substance doctrine take the approach that foreign taxes should always be treated as an expense for purposes of the economic substance doctrine (or, in the case of Notice 98-5, at least in respect of the categories of transactions covered by the Notice). Similarly, the lower court decisions in the *Compaq* and *IES Industries* cases treated the foreign withholding taxes in those cases as expenses in applying the economic substance test, while the appellate court decisions stated that such taxes must be treated as substitutes for the U.S. tax liability that they offset.[232]

To my mind, a more nuanced approach seems to be in order. To the extent a foreign tax offsets U.S. tax liability on income generated by the transaction, the foreign tax should be treated as a substitute for the U.S. income tax liability, for it would be inconsistent with the policy of the foreign tax credit and the capital export neutrality principle to do otherwise. However, to the extent the transaction generates excess foreign tax credits that shelter other foreign source income from tax, it would be appropriate (although not necessarily mandated)[233] as a policy matter to provide that such excess foreign tax should be treated as an expense for purposes of applying the economic substance doctrine to determine whether the transaction is expected to produce sufficient economic profit apart from tax benefits (*i.e.*, the generation of excess credits).

While this refinement in the treatment of foreign taxes for purposes of the applying an economic substance test (either under Notice 98-5 or under the Senate's codification proposal) seems proper, the other issues in applying such a test remain, including (i) the tension between such a test and the Code Sec. 904 limitation; (ii) its inadequacy in distinguishing between "bad" and "good" transactions; and (iii) the challenges of appropriately determining the scope of the transaction, the attribution of items of income and expense (including interest) to the transaction, and the level of relative tax benefits at which a transaction is considered to be "bad."

## F. The Notice 2004-19 Common Law Tests and Guidance on Specific Problematic Features

Notice 2004-19 withdrew Notice 98-5 and replaced the earlier Notice's "enhanced economic profit test"

for examining certain hyped credit transactions with an amorphous approach that would scrutinize such transactions under the following principles of existing law: "the substance over form doctrine, the step transaction doctrine, debt-equity principles, Code Sec. 269, the partnership anti-abuse rules of § 1.701-2, and the substantial economic effect rules of § 1.704-1."

The principles of existing law that were mentioned in the Notice are taken into account by responsible tax counsel in structuring transactions, and most prudently structured transactions comport with those principles. Thus, a fair reading of Notice 2004-19 is that, in the absence of further guidance, the Treasury and the IRS would not be promulgating a set of rules that would restrict and/or curb duplicate benefits FTC arbitrage transactions, nor would the IRS be mounting a general challenge against such transactions or the subset of those transactions that involves hyped credits. Instead, under the Notice, the IRS would challenge only those "outlier" transactions that were imprudently structured and therefore crossed the line between transactions that comply with existing law and those that are "abusive" or "tax shelters."

If the Treasury and the IRS determine to maintain this approach to duplicate benefits FTC arbitrage transactions, they might consider issuing revenue rulings or notices describing structures, or features of structures, that they consider troublesome, so as to influence future taxpayer conduct and minimize the need for mounting separate challenges against individual transactions.

Thus, the Treasury and the IRS could issue specific guidance on the U.S. borrower transactions described in Commissioner Everson's May 2006 report (and on the U.S. lender transactions described in that report in the event they disagree with the views expressed above).[234] The formulation of guidance on these transactions should not present any material implementation issues.

Whether useful and informative guidance can be formulated regarding other features of duplicate benefits FTC arbitrage transactions that the Treasury/IRS might consider to be problematic will depend on the nature of those features and whether, for example, the analysis turns on highly fact-specific criteria or can be generalized and clearly delineated.

## G. Modifying the Rules Governing Common Structuring Techniques

As indicated in Part III, duplicate benefits FTC arbitrage transactions generally employ one of several techniques to enable the U.S. participant to be treated as an equity owner of an interest in an entity for U.S. tax purposes but the non-U.S. participant to be treated as an equity owner (or otherwise to be eligible for benefits) for foreign tax purposes. These techniques include repo and "broken repo" agreements, hybrid securities and hybrid and reverse hybrid entities.

I do not believe that it would be productive or desirable to modify the U.S. tax rules governing the foregoing techniques for the purpose of curbing FTC arbitrage transactions. As noted above,[235] the characterization of repo and "broken repo" agreements as well as hybrid securities for U.S. tax purposes reflect substantive U.S. tax law policies and judgments as to the proper U.S. tax treatment of such agreements and instruments. In addition, these characterizations are deeply ingrained in the law and in commercial and capital markets practices. Indeed, the characterization of repos as financings for tax purposes is relevant to trillions of dollars worth of nonabusive transactions.

Furthermore, modifying the U.S. tax rules governing the foregoing techniques merely because they differ from the tax rules of some foreign countries is likely to be a distinctly ineffective approach to curbing arbitrage transactions since such a change may align the U.S. tax rules with those of some countries but may just as well create new arbitrage opportunities with respect to other countries. And modifying the U.S. tax rules merely because they differ from the tax rules of some other countries smacks of the same abdication of responsibility as the foreign conformity rule that was criticized in Part VII.B.2 above.

While at least some of the foregoing considerations are also relevant in respect of the CTB rules that facilitate the formation of hybrid and reverse hybrid entities, arguably stronger arguments can be made for curtailing the scope of the CTB rules if such a step would effectively curb the formation of undesirable structures given the inherent formalism and lack of substance in a CTB election. Indeed, a Joint Committee of Taxation paper has raised the possibility of requiring a separate business entity organized under foreign law that has only a single member to be treated as a corporation for federal income tax purposes, in order to address certain perceived abuses in the CFC area.[236]

I believe that it would be unwise to curtail CTB elections, for several reasons.[237] First and foremost, the CTB election is merely a procedural device to simplify the accomplishment of U.S. tax characterization results that in many (albeit not all) cases would be possible to accomplish anyway, but at significantly greater

expense and effort. In the decade since the CTB rules have been promulgated, they have saved enormous sums of money and effort that would otherwise have been wasted on legal and tax structuring, so although the CTB election is merely a procedural device, it has significant salutary effects. It makes very little sense as a tax policy matter to foreclose a procedural simplification mechanism that has broad application and utility for a wide range of commercial activities in order to make it more difficult for some taxpayers to structure transactions that are problematic, where those taxpayers that have a sufficiently strong interest in structuring such problematic transactions likely will still be able to do so. Instead, the problematic substantive cases should be addressed head-on.

Second, while many duplicate benefits FTC arbitrage transactions involve non-U.S. entities that file CTB elections, others involve U.S. entities. Even if Congress or the Treasury/IRS were tempted to curtail CTB elections for non-U.S. eligible entities, it is unlikely that they would do so for domestic eligible entities, or that they could draw satisfactory distinctions between those limited situations where a CTB election would no longer be available and other cases.

Third, only a portion of the duplicate benefits FTC arbitrage transactions rely on CTB elections. Thus, curtailing CTB elections is not likely to be an effective approach to curbing such transactions.

Part III.B mentions several of the many technical rules that need to be navigated successfully in order to properly structure a FTC arbitrage transaction. Undoubtedly at least some of those rules are imperfect or vague, and could be improved in ways that would curb at least some transaction structures. To my knowledge, however, there is no "silver bullet" lurking in the intricate rules that would cure the problem as a general matter.

## H. Maintaining Conformity and Consistency Among Various Rules and Contexts Including the Partnership FTC Allocation Regulation

As in the case of other rule-making endeavors, an important consideration in promulgating rules to address various FTC arbitrage structures is to ensure that a degree of consistency be maintained among the various rules and contexts, and that any differences in approach or result conform to a principled rationale, so that overall the rules are coherent.[238] In the course of this paper, I have mentioned several noteworthy consistency and conformity considerations. In this Paragraph, I make a few observations concerning consistency and conformity considerations that are relevant to the relationship between possible approaches to dealing with duplicate benefits FTC arbitrage transactions and FTC separation structures, on the one hand, and the partnership FTC allocation regulation,[239] on the other hand.

One possible way to look at duplicate benefits FTC arbitrage transactions is to view them as involving an improper allocation of foreign tax credits between the U.S. and foreign participants. In other words, inasmuch as these transactions typically involve a U.S. participant and a non-U.S. participant providing funds to a joint investment entity that incurs foreign tax, an alternative approach to those discussed above might be to say that the foreign tax credit should be allocated to the U.S. and non-U.S. participants based on the relative economic interests of the participants. This could be measured by the relative amounts of profit distributions to each participant (including, for example, by treating "interest" payments to a participant as a profit distribution for this purpose), or perhaps by the relative amounts invested in the entity (regardless of the characterization of such amounts as debt or as equity). A potential benefit of such an approach is that it would provide a relatively simple and arguably fair method for determining the consequences of these transactions.

At first blush, it might appear that such an approach would be consistent with the partnership FTC allocation regulation since this approach would match the foreign tax credit with the respective participants' respective shares of the income from the investment. As previously noted, the partnership FTC allocation regulation adopts a matching approach that requires a partnership to allocate CFTEs (creditable foreign tax expenses) in proportion to the partners' distributive shares of income to which the credits relate.

However, the partnership FTC allocation regulation adheres to U.S. tax principles in determining the partners' respective distributive shares of income to which the CFTEs relate,[240] and therefore respects the characterization of instruments as debt or equity for U.S. tax purposes. On the other hand, this suggested approach would completely ignore U.S. tax principles relating to the characterization of the non-U.S. participant's investment as debt and the U.S. participant as the owner of the entity that pays the foreign tax. Thus, this suggested approach would be inconsistent with basic U.S. tax principles and with the partnership FTC allocation regulation.

Moreover, the partnership FTC allocation regulation provides that a preferred allocation or guaranteed payment (within the meaning of Code Sec. 704(c)) or other amount, other than certain inter-branch payments, that is deductible for foreign tax purposes is not included as an item of partnership income.[241] Consequently, such a preferred allocation or guaranteed payment that is treated as deductible for foreign tax law purposes would not attract any CFTEs. This seems appropriate since the income attributable to such a payment was not included in the foreign tax base and is akin to a deductible interest payment. Also, in the case of a partnership, after deduction of the preferred allocation or guaranteed payment, there will be owners of the common partnership interest who will be allocated the residual income that corresponds to the tax base that bears the tax, so it makes sense to attribute the CFTEs to those residual owners in a manner that corresponds to their share of the tax base.[242]

It is worth noting what the partnership FTC allocation regulation does and does not accomplish in respect of FTC arbitrage transactions. It clearly achieves its primary goal of preventing naked allocations of CFTEs to a partner without commensurate allocations of income. It may also have a collateral impact on certain other categories of partnership FTC arbitrage transactions, although this impact is a side-effect of the deductible preferred allocation / guaranteed payment rule described above and is not a complete solution to such transactions in the event they are indeed considered problematic. Thus, the regulation may foreclose partnership FTC arbitrage structures in which the U.S. participant is receiving preferred allocations or guaranteed payments that are deductible for foreign tax purposes.[243] However, the regulation would leave untouched those structures in which the non-U.S. participant is treated as a lender for U.S. tax purposes (*e.g.,* under a repo or hybrid security). Nor would the regulation affect entities that are not treated as partnerships for U.S. tax purposes (including disregarded entities and corporations).

From a consistency perspective, one might consider extending the foregoing concept to duplicate benefits FTC arbitrage transactions that do not involve partnerships, so as to deny a foreign tax credit to the U.S. participant to the extent that the related income stream is treated as deductible for foreign tax purposes. Before doing so, however, it would be necessary to consider a variety of issues, including (i) the scope of any such approach[244]; (ii) whether such an approach is inconsistent with other substantive tax principles, such as those that relate to the treatment of repos, beneficial ownership, hybrid securities and corporations and their shareholders; and (iii) whether it implicates any administrability or other concerns.

The partnership FTC allocation regulation appropriately makes some concessions to administrability concerns, and thus, in order to avoid potentially complex tracing problems, contains simplifying conventions for matching CFTEs with related income in the case of timing and base differences between U.S. and foreign tax law,[245] as well as in the case of inter-branch payments.[246] In general, the CFTEs relating to inter-branch payments are allocated to the CFTE category that includes the items attributable to the relevant activity (or activities) of the recipient branch, but the taxpayer can establish that a different allocation is in accordance with the partners' interest in the partnership if it can substantiate that the CFTEs relate to items of income (or inter-branch payments) that are allocated in a different manner.[247] As illustrated in an example in the regulation, this rule enables taxpayers to separate CFTEs from the related income and to generate hyped credits.[248] While the administratively simpler approach of the regulation is sensible for routine commercial arrangements, it would seem desirable for the regulation to contain a targeted anti-abuse rule granting the IRS the authority to require tracing where the arrangements are undertaken primarily for a tax-motivated purpose (such as in a situation involving passive investments and a significant amount of hyped credits).

As an aside, the foregoing brief discussion concerning the partnership FTC allocation regulation illustrates some of the points made above regarding the challenges of rulemaking in this area. This regulation is well conceived, and it generally strikes a good balance between conceptual purity and administrability, vague general principles and overly prescriptive details that may be over- or under-inclusive, but nonetheless there is room for improvement.

## I. Domestic Law vs. Treaty Approaches and International Coordination

An observant reader of this paper cannot help but note that the approaches discussed in this Part VII all involve domestic legislation or regulation, rather than international coordination through treaties or mutual agreement procedures with non-U.S. governments or within the Organization for Economic Cooperation and Development (OECD). This might be somewhat surprising to those who consider FTC arbitrage (and other international tax arbitrage) transactions to violate the single tax principle, as described in Part V above.

However, in my view, as noted in Part V above, outside the treaty context, it is difficult to perceive a recognized single tax principle, and even in the treaty context, this principle is given scant operative effect. Moreover, while treaties mitigate double taxation by ensuring the effective availability of a foreign tax credit,[249] the foreign tax credit is fundamentally a creature of domestic law and regulation, and the FTC arbitrage transactions generally do not rely on treaty provisions (or, if they do, only peripherally).[250]

Consequently, the analysis in Part VI of whether anything is wrong with FTC arbitrage transactions, and if so what, turned virtually entirely on U.S. tax and economic policy issues. Similarly, the potential approaches discussed in this Part VII to implementing any changes in the treatment of such transactions focused on domestic legislative and regulatory solutions. Indeed, this paper takes a decidedly negative view of those approaches that take significant account of the foreign tax treatment of the transaction.[251]

More generally, I am inclined to believe that even where an international arbitrage transaction relies on a treaty provision, in many cases it will be preferable—if and to the extent possible—for Congress or the Treasury/IRS to implement any curbs on such transaction through domestic legislation or regulation rather than through the treaty process, for several reasons.[252] Almost invariably, given the similarity among most treaties, the issue or transaction structure will not be limited to a single treaty. Negotiating amendments or explanatory notes to treaties is a slow and unwieldy process.[253] Such negotiations may require the United States to make concessions to the treaty partner, which the Treasury may consider to be unwarranted if it believes the issue or transaction structure to be addressed is inconsistent with the intention of the treaty. The hurdles to taking timely action (including the ratification process for actual treaty amendments) will be compounded to the extent these changes need to be implemented in multiple treaties. Also, to the extent that the solution to a particular problem requires the formulation of a detailed set of rules, regulations are generally a more suitable format than a treaty (or notes thereto or explanations thereof) for promulgating such guidance.

Therefore, while undoubtedly there will be situations in which a treaty-based solution is necessary and appropriate,[254] as a general proposition I would be inclined to view such solutions as less desirable than domestic legislative or regulatory approaches.

A possible exception, where which a treaty-based solution might be promising, is where there is a discrete area of duplicate tax benefits being claimed in transactions involving the United States and another country, and where it might be effective to address such duplicate benefits through an agreement—similar to the recently negotiated U.K.-U.S. DCL Competent Authority Agreement—that would permit or require the taxpayers to jointly elect to claim the benefits in one of the countries (but not both).[255]

A related question is the extent to which the approach that is adopted by the United States should take into account the likely effect of that response on other countries and the possible changes in their tax laws and consequent modifications in taxpayer behavior (*i.e.,* what might be termed the "reflectiveness" issue). A number of commentators make interesting observations regarding the impact of this issue (including the potential relevance of game theory) in mapping out a strategy for dealing with international tax arbitrage situations.[256] To my mind, certainly the United States should be mindful of the anticipated and actual implications for taxpayers and foreign governments (and their responses) of any approaches that it adopts to an international tax arbitrage transaction or structure. However, I believe that for the most part, notwithstanding that international tax arbitrage necessarily involves the tax rules of more than one country, it is likely that reflectiveness considerations will play only a minor role in the evaluation of the issues presented or in the solutions that are adopted because (as in the case of the foreign tax credit) the crux of the issues and solutions will typically be U.S. tax-centric.

Lest I be accused of being an inveterate unilateralist in international tax matters, let me emphasize that there is an extremely important role for coordination between the Treasury/IRS and other tax authorities. International tax arbitrage often involves complicated structuring and it is usually practiced in private transactions that are difficult to identify and to reverse engineer. As is often the case in domestic tax planning (both of the legitimate and the tax shelter type), the IRS and other tax authorities can very easily find themselves woefully behind in learning about these activities, auditing and challenging troublesome transactions, and issuing guidance to forestall additional "bad" transactions from being consummated. In an effort to rectify this imbalance, it is essential that tax authorities share information about transactions, structures and the parties involved. Such cooperation is likely to prove to be a powerful tool in weeding out abusive transactions (which are excluded from the scope of international tax arbitrage, as defined

for purposes of this paper),[257] including situations in which the participants take inconsistent factual positions in describing and reporting the transaction to their respective tax authorities. Depending on the circumstances, it may also be desirable for tax authorities to discuss their respective legal positions regarding the issues presented and the steps that they are taking to challenge specific transactions or to curb future transactions. Thus, the steps taken by the United States and other governments in recent years to share information and coordinate examination efforts regarding such transactions[258] should be applauded, encouraged and expanded.

## J. Regulatory Authority and Summary

This Part VII reviewed several possible approaches that might be considered in the event that Congress or the Treasury/IRS determine that duplicate benefits FTC arbitrage transactions should be curbed in their entirety or, alternatively, to the extent they involve cross-crediting (either at all or above a certain level) or other troublesome features. If such transactions were to be curbed completely, the most effective approach would appear to be the enactment of a separate Code Sec. 904 "basket" for such transactions (discussed in Part VII.C.4 above). Curbing only those transactions that involve cross-crediting (or significant and abusive cross-crediting) poses challenges in delineating between "good" and "bad" transactions and quantifying the relevant criteria for applying such an approach. It should be possible to curb U.S. borrower transactions (and, if the Treasury/IRS disagree with the views expressed above, U.S. lender transactions) without much difficulty. Whether useful and informative guidance can be formulated regarding other features of duplicate benefits FTC arbitrage transactions that the Treasury/IRS might consider to be problematic will depend on the nature of those features and whether, for example, the analysis turns on highly fact-specific criteria or can be generalized and clearly delineated.

Any steps to curb duplicate benefits FTC arbitrage transactions—and especially curbs on those transactions that involve hyped credits—need to be reconciled with the Code Sec. 904 limitation in three respects.

First, a policy decision needs to be taken regarding the proper scope and function of the Code Sec. 904 "baskets," which needs to articulate a basis and a cognizable standard for overriding or limiting whatever baskets are adopted for ordinary course business and investment activities and subjecting certain identified categories of transactions to a different rule or an additional restriction. Considerations relevant to identifying categories of transactions that might be subject to a different rule were discussed in Part VI.B above.

Second, the foregoing policy decision needs to be translated into specific criteria that delineate the precise contours of the identified categories of transactions, prescribe the consequences applicable to them and clearly differentiate those transactions from those that are subject to the generally applicable rules under Code Sec. 904. This Part VII touched upon some of these implementation issues.

Third, while Congress clearly has the authority to do both of the foregoing, in the event Treasury and the IRS decide to take action on their own, they will need to consider the regulatory authority for such action. Specifically, the Treasury and the IRS must evaluate whether their action is (i) inconsistent with the existing statutory scheme, including Code Sec. 904, and (ii) authorized under their general authorization to issue "all needful rules and regulations for the enforcement of this title."[259] In this regard, to date Congress has not enacted legislation that has been requested several times by the Executive Branch to provide the Treasury with specific authority to deal with foreign tax credit abuses.[260]

Clearly, the Treasury and the IRS do not have the authority to prescribe a new Code Sec. 904 "basket" encompassing income from, say, duplicate benefits FTC arbitrage transactions or hyped credit transactions. As noted in Part VII.E above, it has been suggested that Notice 98-5 was the Treasury/IRS' attempt to deal with the regulatory authority problem by seeking to invigorate (and refashion) the traditional economic substance test and use it as a weapon to challenge what it considered to be abusive hyped credit transactions. Unfortunately for those efforts, two federal courts of appeals (in *Compaq* and *IES Industries*) seem to have been unwilling to reinterpret the economic substance test so as to be a more useful weapon in the war against abusive FTC transactions by treating foreign tax credits as an expense for purposes of that test.[261]

Perhaps the Treasury and the IRS would have been more successful if they had adopted the more nuanced approach, suggested in Part VII.E above, of treating foreign taxes as expenses only to the extent the transaction generates "excess" foreign tax credits that shelter other foreign source income from tax, since it is easier to view such "excess" credits as the sort of tax benefit that the economic substance doctrine is supposed to be testing.

Furthermore, in *Compaq* and *IES Industries*, the courts were asked to interpret the historic, judicially created economic substance doctrine. There is reason to believe that if the Treasury and the IRS were to promulgate interpretive regulations under Code Sec. 901 containing a general anti-abuse rule along the lines described in Part VII.B.1 above and containing specific elaborations of that rule, including an "enhanced economic profit" test along the lines of Notice 98-5 (but hopefully an improved version thereof), a court would consider such a regulation to be an appropriate and valid exercise of the Treasury/IRS' regulatory authority.

In lieu of an "enhanced economic profit" test, the Treasury/IRS might consider promulgating a curb of hyped credit transactions (or transactions with other troublesome features) based on the approach discussed in Part VII.D above, although as noted above such an approach presents formidable implementation challenges. As a regulatory authority matter, this approach could be grounded on an interpretation of the business purpose doctrine. Thus, the Treasury/IRS might promulgate an anti-abuse regulation as described above that would include, as an elaboration, a provision to the effect that transactions meeting certain specified criteria (as discussed in Part VII.D) will be deemed to lack adequate business purpose under the anti-abuse provision. In the absence of such a regulation, I would expect that a court would be unlikely to sustain a challenge of a hyped credit transaction on the grounds that it lacks an adequate business purpose since the economic compensation that the U.S. participant typically receives from the foreign participant for the foreign tax benefits that it enjoys (*e.g.*, through an enhanced yield on the investment, funding at an attractive rate or an outright payment for the tax benefits) should satisfy the requirements for a business purpose under existing law.

In summary, I believe that the courts should sustain against a lack-of-regulatory-authority challenge a thoughtfully designed regulation that (i) articulates a clear policy as to those categories of transactions that are abusive and why they are inconsistent with existing rules (including the Code Sec. 904 limitation), and (ii) precisely delineates between "good" and "bad" transactions. As the foregoing discussion in Parts VI and VII illustrates, however, there are numerous and formidable issues, challenges and choices to be confronted in designing such a regulation.

# VIII. Conclusion

International tax arbitrage transactions in general, and duplicate benefits FTC arbitrage transactions in particular, present unusually difficult policy and practical implementation challenges to the tax administrator.

Neither an approach that views international tax arbitrage in general, or the particular categories of transactions discussed herein (and variations thereon), as *per se* improper as a policy matter and worthy of interdiction, nor an approach that considers such transactions beyond reproof so long as they comply with the tax rules of each relevant country, appears to be appropriate as a tax policy matter. Instead, a more flexible factors-based analysis of each particular category seems to be required in order to properly reflect and weigh the policy and practical implications presented by that category. In this context, one size does *not* fit all.

In terms of the relevant factors for evaluating particular categories of transactions, economic efficiency policy considerations provide high-level guiding principles but often are eclipsed by more immediate and tangible political, fiscal and economic concerns. Fairness, preserving the tax base and addressing perceptions of abuse are also relevant, but their implications for particular situations are often elusive (especially when the appropriate baseline for evaluating these criteria is debatable). The factual and legal contexts as well as implementation and administrability considerations should all play an important role in the analysis.

At the most basic level, many of the transactions discussed herein pose the issue whether there is anything improper as a policy matter with a transaction that complies with the substantive tax rules of two countries but produces aggregate tax benefits that are greater than what would exist if all participants were in the same country, especially where the U.S. participant is deriving an economic benefit from the non-U.S. participant (*e.g.,* by way of a reduced financing cost on funds provided by the non-U.S. participant, enhanced yield on the investment or an outright payment from the non-U.S. participant for the foreign tax benefits).

Even those duplicate benefits FTC arbitrage transactions that involve potentially troublesome features require that comprehendible and sensible distinctions be drawn on policy and practical grounds between "bad" and "good" situations, and that such distinctions be reconciled with the policies and rules of the Code Sec. 904 limitation.

All this is not to say that the U.S. government should not or cannot curb any or all of such transactions, but rather that the decisions whether, to what extent and how to do so implicate a complicated web of issues.

This paper has endeavored to lay out and evaluate the most important considerations relevant to deciding whether any particular categories of transactions are problematic as a policy matter and therefore should be curbed, as well as how any such curbs might be implemented. A summary of my views as to what categories of duplicate benefits FTC arbitrage transactions might be curbed is set forth in Part VI.B.12, and a summary of my views regarding the implementation aspects is set forth in Part VII.J.

Finally, to a considerably greater extent than might have been imagined, it appears that the crux of the issues and solutions will typically be U.S. tax-centric, and that bilateral or multilateral solutions will generally not be necessary or efficient to implement, although there is a very important role for coordination between the Treasury/IRS and other tax authorities in identifying and combating abusive transactions.

## Endnotes

* This paper takes account of developments as of December 15, 2006.

1 For illuminating discussions of the topic (including differing definitions of "international tax arbitrage" and views as to whether it is even appropriate to use the term "arbitrage" to describe the phenomena under consideration), *see, e.g.,* Gregory May, *Getting Realistic About International Tax Arbitrage*, Taxes, Mar. 2007; Luca Dell'Anese, Tax Arbitrage and the Changing Structure of International Tax Law (2006); Mitchell Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 Emory L. J. 89 (2004); Daniel N. Shaviro, *More Revenues, Less Distortion? Responding to Cross-Border Tax Arbitrage*, 1 N.Y.U. J. L. & Bus. 113 (2004); Diane M. Ring, *One Nation Among Many: Policy Implications of Cross Border Tax Arbitrage*, 44 B.C. L. Rev. 79 (2002); Julie Roin, *Taxation Without Coordination*, 31 J. Legal Stud. 61 (2002); H. David Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the "International Tax System,"* 53 Tax L. Rev. 137 (2000); Reuven S. Avi-Yonah, *Commentary*, 53 Tax. L. Rev. 167 (2000); Phillip R. West, *Foreign Law in U.S. International Taxation: The Search for Standards*, 3 Fla. Tax Rev. 147, 171–84 (1996).

2 May, *supra* note 1.

3 *See* Code Sec. 243. Unless otherwise indicated, all section references in this paper are to the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury regulations promulgated thereunder.

4 *See* Code Sec. 1502 and the regulations thereunder.

5 *See* Reg. §§301.7701-1 through 301.7701-3.

6 71 FR 44,240 (Aug. 4, 2006). The proposed regulations, which are effective for foreign taxes paid or accrued during tax years of the taxpayer beginning on or after January 1, 2007, are discussed in Part IV, Paragraph 3, and Part VII.A below.

7 *Guardian Industries Corp.*, FedCl, 2005-1 ustc ¶50,263, 65 FedCl 50.

8 *Id.*, at 53.

9 The Code Sec. 904 limitation is discussed in Part IV, Paragraph 4, below.

10 *See* Rev. Rul. 72-197, 1972-1 CB 215 (owners of a reverse hybrid entity were entitled to the foreign tax credit since they were liable for the tax under foreign law, although they would not have to include the income until it was distributed to them). The example assumes that the Opcos' income is not includible as subpart F income under Code Sec. 951.

11 The benefits would be maximized if, for example, Holdco were to receive dividends from the Opcos in an amount that slightly exceeded its tax liability and were to distribute such excess to U.S. Parent. In that case, its entire earnings pool (which would be nominal) and foreign tax credit pool would be distributed to U.S. Parent.

12 It is not always clear whether and to what extent a transaction involves cross-crediting or, instead, is self-sheltered. As discussed in Part VII.D below, this determination depends on the manner in which interest expense and various other items are taken into account.

13 Such duplicate benefits FTC transactions are not the only type of hyped credit transaction. The FTC separation structures discussed in Part II.A above also involve hyped credits. In addition, cross-crediting arises in numerous *bona fide* commercial contexts. For two examples, *see* note 219 and the accompanying text below.

14 *See* Part IV, Paragraph 4, below.

15 *See* Part VII.D and E below.

16 This example bears some resemblance to Example 5 in Notice 98-5, 1998-1 CB 334, *withdrawn by* Notice 2004-19, 2004-1 CB 606.

17 In fact, multinationals have engaged in these types of transactions for many years, since long before the rise in international tax arbitrage transactions involving creditable taxes.

18 Alternatively, if the investment entity is not a member of the U.S. participant's consolidated tax group, the U.S. participant may defer taking distributions of profits until after the non-U.S. participant no longer owns an interest in the entity and then liquidate the entity under Code Sec. 332.

19 Indeed, if in Example 7 Newco had been a Country X entity, the transaction would constitute a duplicate benefits FTC arbitrage transaction with cross-crediting, generally producing the same net after-tax benefits to USCo as Example 7 (assuming USCo is able to utilize both the foreign tax credit and the interest deduction).

20 For a more detailed description of repos, *See* Stephen A. Lumpkin, *Repurchase and Reverse Repurchase Agreements*, Instruments of the Money Market (Timothy Q. Cook and Robert K. LaRoche, Eds., 1993), made available by the Federal Reserve Bank of Richmond at *www.richmondfed.org/publications/economic_research/instruments_of_the_money_market/instruments.pdf.*

21 *See, e.g.,* Darryll Hendricks, John Kambhu & Patricia Mosser, *Systemic Risk and the Financial System* 19 (Fed. Res. Bank of NY, NAS-FRBNY Conference on New Directions in Understanding Systemic Risk, May 2006), *available at www.newyorkfed.org/registration/research/risk/background.pdf.*

22 *See, e.g., Am. Nat'l Bank of Austin*, CA-5, 70-1 ustc ¶9184, 421 F2d 442 (bank acquiring newly issued securities directly from issuer pursuant to agreement to retransfer to dealers characterized as a secured lender*); First Am. Nat'l Bank of Nashville*, CA-6, 72-2 ustc ¶9694, 467 F2d 1098 (same); Rev. Rul. 79-195, 1979-1 CB 177 (sale of notes pursuant to a "sales and repurchase" agreement treated as secured loan); Rev. Rul. 77-59, 1977-1 CB 196 (purchase and resale of U.S. Treasury obligations treated as secured loans where purchaser assumed no benefits and risked no losses from changes in market value or interest rates); Rev. Rul. 74-27, 1974-1 CB 24 (sale and repurchase of municipal bonds by customers to and from bank treated as secured financings; customers (and not bank) treated as owners of bonds and entitled to tax-exempt interest thereon). In *Nebraska v. Loewenstein*, 513 US 123 (1994), the U.S. Supreme Court held that sale-repurchase agreements involving U.S. Treasuries should be characterized as financings for purposes of the exemption

from state tax on income from Treasuries.

[23] Under the U.K. rules relating to sale and repurchase transactions, the excess of the amount paid by the U.K. participant on the "repurchase," over the amount received by the U.K. participant on the "sale," is treated as a tax deductible interest charge. Where there is no actual price differential (which usually will be the case where the intermediary is not required to make any payments to the U.K. participant over the term of the transaction that are representative of dividends paid on the underlying shares), such a differential is deemed to arise. The rules achieve this result by assuming first that the intermediary is required to make such in lieu, or substitute, payments (referred to as "manufactured dividend" payments) and second that the "repurchase" price is increased by the amount of those payments. The U.K. participant thereby obtains interest deductions in the U.K. related to the real dividends paid on the underlying shares. The deemed "manufactured dividend" payments made by the intermediary are not taxable in the hands of the U.K. participant. Under the U.K. rules relating to "manufactured dividends," the U.K. participant is treated as receiving actual dividends from the issuer. These dividends are not taxable; there is a general rule in the U.K. that dividends paid by one U.K. tax resident company to another U.K. tax resident company are free from tax (provided that the recipient company is not a share dealer).

[24] *See* generally William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1970).

[25] *See* Reg. §§301.7701-1 through 301.7701-3. The inability to elect tax-transparent status for *per se* corporations is rarely if ever a problem in FTC-related arbitrage transactions.

[26] U.S. taxpayers that do not have multinational operations or foreign source income can participate in duplicate benefits FTC arbitrage transactions that involve self-sheltering rather than cross-crediting, in reverse FTC arbitrage and U.S. withholding tax claims transactions, and in various forms of arbitrage transactions that do not rely on the foreign tax credit.

[27] Some of the complexities in determining the manner in which various items of income and expense should be taken into account (and the amount thereof) in determining economic profit are described in Parts VII. D and E below.

[28] *See* Part VII.E below.

[29] *See, e.g.*, *American Chicle Co.*, SCt, 42-2 USTC ¶9512, 316 US 450; Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 852 (1987) (the "1986 Blue Book").

[30] *Id.*

[31] In addition to the rules summarized under the five themes discussed below, a taxpayer claiming a foreign tax credit is required to substantiate its entitlement, including by providing upon request a receipt for or other evidence of such tax payment. *See* Code Sec. 905(b); Reg. §1.905-2.

[32] *See* Reg. §1.901-2(a)(1)(ii), (3) (requiring that "predominant character of a foreign tax is that of an income tax in the U.S. sense," which means that "the foreign tax is likely to reach net gain"); Reg. §1.901-2(b) (a foreign tax is likely to reach net gain only if the tax satisfies each of the realization, gross receipts and net income requirements set forth in Reg. §1.901-2(b)(2), (b)(3), and (b)(4) respectively); Reg. §1.901-2(b)(2) (a foreign tax satisfies the realization requirement if it is based on events that would result in realization under U.S. tax principles, or based on prerealization events if certain conditions are met); Reg. §1.901-2(b)(3) (a foreign tax satisfies the gross receipts requirement if it is imposed on the basis of gross receipts or on a mark-to-market basis); Reg. §1.901-2(b)(4) (a foreign tax satisfies the net income requirement if is computed by reducing gross receipts by significant costs and expenses attributable to such receipts).

[33] Reg. §1.903-1(a) and (b)(1) (a foreign tax is an "in lieu of" tax only if it meets the substitution requirement (*i.e.,* the tax in fact operates as a tax imposed in substitution for, and not in addition to, an income tax)).

[34] Reg. §1.901-2(a)(2)(i); *see also* Reg. §1.901-2(e)(5) (an amount is a compulsory tax 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 treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law 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)").

[35] Reg. §1.901-2(a)(2)(i), (ii)(B). Special rules apply to so-called dual capacity taxpayers, which are subject to a foreign tax and also receive an economic benefit from the foreign state imposing the tax. *See* Reg. §§1.901-2(a)(2)(ii), 1.901-2A.

[36] Reg. §1.901-2(c).

[37] Reg. §1.901-2(e)(2). ("It is not reasonably certain that an amount will be refunded, credited, rebated, abated or forgiven if the amount is not greater than a reasonable approximation of final tax liability to the foreign country.")

[38] Reg. §1.901-2(e)(3)(i)(A).

[39] CCA 200532044 (May 5, 2005). Sub was a resident of both the United States and Country X because it was incorporated in the United States, but had its place of management in Country X. The U.S.-Country X treaty provides that the competent authorities may settle the issue of residency of a dual resident corporation by mutual agreement, or in the absence of such agreement, the corporation would be considered resident of neither state for purposes of the treaty. If the competent authorities determined that Sub was solely a U.S. resident (as the IRS indicated was likely), it would have had no Country X tax liability. The IRS concluded that because the tax was not compulsory, it was not creditable under Reg. §1.901-2(e)(5).

[40] *See* Part VII.C.2 below for a discussion of the subsidy rule in the context of duplicate benefits FTC arbitrage transactions.

[41] West, *supra* note 1, at 149.

[42] *M.D. Biddle*, SCt, 38-1 USTC ¶9040 302 US 573.

[43] *Id.*, at 578–79:

> Hence the board's finding, supported as it is by much expert testimony, that "the stockholder receiving the dividend is regarded in the English income tax acts as having paid 'by deduction or otherwise' the tax appropriate to the dividend" is not conclusive. At most it is but a factor to be considered in deciding whether the stockholder pays the tax within the meaning of our own statute. That must ultimately be determined by ascertaining from an examination of the manner in which the British tax is laid and collected what the stockholder has done in conformity to British law and whether it is the substantial equivalent of payment of the tax as those terms are used in our own statute.

[44] *Guardian Industries Corp.*, *supra* note 7 (holding further that because the Luxembourg parent was a disregarded entity for U.S. tax purposes, its U.S. owner was eligible for a direct foreign tax credit).

[45] *See also* Part VII.H below (discussing the new partnership FTC allocation regulation in Reg. §1.704-1(b)(4)(viii)).

[46] *See* Reg. §1.904-6(a)(1)(iv) (special rule for base and timing differences). *See* also Code Sec. 904(d)(2)(H) (as enacted by the American Jobs Creation Act of 2004 (P.L. 108-357), §404(e) (2004), effective for tax years beginning after December 31, 2006) (providing that taxes imposed by a foreign country on an amount that is not considered income under U.S. tax principles be placed in the general income basket, and that for the 2005–2006 tax years, taxpayers may elect to place such tax in the financial services basket or the general income basket under the old basket system).

[47] N.Y. State Bar Ass'n Tax Section, *Report on Regulation Section 1.901-2(f)(3) and the Allocation of Foreign Taxes Among Related*

*Persons, reprinted in* 107 TAX NOTES 1013, 1022 (2005) (the "*NYSBA Section 1.901-2(f)(3) Report*").

[48] The *Biddle* case (*supra* notes 42 and 43 and accompanying text) is widely regarded as one of the earliest statements of the technical taxpayer rule. In that case, the Supreme Court held that a U.S. shareholder of a U.K. corporation that was subject to the U.K. integrated tax regime was not entitled to claim a direct foreign tax credit under the predecessor of Code Sec. 901 because "our statutes ... have never treated the stockholder for any purpose as paying the tax collected from the corporation. Nor have they treated as taxpayers those upon whom no legal duty to pay the tax is laid." *Biddle, supra* note 42, 302 US, at 581.

[49] Reg. §1.901-2(f)(2)(i) (2005) elaborates on this pronouncement by stating that, "[t]ax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability." Thus, if a foreign country imposes a withholding tax on interest income earned by a U.S. lender and the borrower agrees to "gross up" its interest payments so that the U.S. lender is made whole for such tax, the U.S. lender nonetheless is entitled to claim a foreign tax credit for the full amount of the withholding tax.

[50] *See, e.g., id. See* also Reg. §1.901-2(f)(2)(ii) Example (3) (2005) (contractor is eligible for credit in respect of a country X tax imposed on its income from a contract to construct a naval base notwithstanding that country X agrees to assume any such tax liability). *See generally* James M. Peaslee, *Economic Substance Test Abused: Notice 98-5 and the Foreign Law Taxpayer Rule*, 79 TAX NOTES 79, 81–83 (1998).

[51] This is actually a slight overstatement, as explained in the *NYSBA Section 1.901-2(f)(3) Report,* since cases involving Brazilian and U.K. withholding taxes on interest have consistently held that the U.S. lender is treated as the person who "paid" the withholding tax and had "legal liability" therefore because it earned the income, even though the foreign tax laws at issue in these cases imposed an obligation to pay the tax only on the borrower and did not contain any remedy against the U.S. lender. *See Norwest Corp.*, CA-8, 95-2 USTC ¶50,618, 69 F3d 1404; *Continental Illinois Corp.*, CA-7, 93-2 USTC ¶50,400, 998 F2d 513; *Nissho Iwai American Corp.*, 89 TC 765 (1987); *Gleason Works,* 58 TC 464 (1972). While these cases could be considered departures from a strict application of the technical taxpayer rule, it would appear that they are consistent with Biddle's admonition (described in note 43 and the accompanying text above) that U.S. tax principles should govern the determination of who "paid" the tax. For example, the court in the Continental Illinois case stated:

> 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. But the IRS treats it as an income tax, and the correct characterization is not important to this case …" *Continental Illinois*, *id.*, at 518-19 (citations omitted).

In that case and the other Brazilian withholding tax situations, the courts were influenced by the fact that, as a practical matter, the interest payment could not be made unless and until the Brazilian withholding tax was paid because proof of payment of the tax was a condition to obtaining the foreign currency to make the interest payment. *See, e.g., id.,* at 518; *Nissho Iwai American Corp.*, *id.*, at 769. No such factor was present in *Gleason Works*, where the court very clearly relied on U.S. federal income tax concepts regarding withholding taxes to conclude that the U.K. withholding tax on interest was imposed on the U.S. lender even though it was collectible only from the borrower. *Gleason Works, id.,* at 479. *See NYSBA Section 1.901-2(f)(3) Report, supra* note 47, at 1017.

However, as discussed below, Proposed Reg. §1.901-2(f)(1) provides that, "[i]n general, foreign law is considered to impose legal liability on the person who is required to take the income into account for *foreign* income tax purposes." (Emphasis added.)

[52] *NYSBA Section 1.901-2(f)(3) Report, supra* note 47, at 1016.

[53] CCA 200514010 (Dec. 8, 2004). The CCA is inconsistent with Rev. Rul. 72-514, 1972-2 CB 440, which ruled that a U.S. parent could claim a foreign tax credit for withholding tax on loans to its foreign subsidiaries that were made through a U.S. bank under an agency agreement, in order to minimize the risk that payments by the subsidiaries would be subject to exchange controls precluding payments on inter-company loans (presumably because the foreign country would not be aware of the agency arrangement). Similarly, Reg. §1.901-2(f)(2)(ii), Example (2) (2005) looks through a nominee arrangement without inquiring whether the foreign country treats the nominee or the principal as the beneficial owner.

[54] These provisions are discussed in Paragraph 5 below.

[55] The taxpayers prevailed in two cases involving aggressively structured transactions of this nature. *See Compaq Computer Corp.*, CA-5, 2002-1 USTC ¶50,144, 277 F3d 778; *IES Industries, Inc.*, CA-8, 2001-2 USTC ¶50,471, 253 F3d 350. *See also* Notice 98-5, *supra* note 16, Examples 1, 2 and 3 (involving acquisitions of income streams that are subject to withholding tax where there is little or no profit apart from the foreign tax credit).

[56] *See* Reg. §1.901-2(f)(3) (2005) ("If foreign income tax is imposed on the combined income of two or more related persons (for example, a husband and wife or a corporation and one or more of its subsidiaries) *and they are jointly and severally liable for the income tax under foreign law*, foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of the tax, regardless of which person actually pays the tax") (emphasis added); Rev. Rul. 58-518, 1958-2 CB 381 (holding that where a tax is assessed against a parent on the combined income of its subsidiaries, subject to a credit for taxes paid by its subsidiaries, the parent is still eligible for a foreign tax credit on the tax that it pays in respect of the income of its subsidiaries since it is legally liable for the tax); Rev. Rul. 72-197, 1972-1 CB 215 (where the entity in question was a reverse hybrid (*i.e.,* a corporation for U.S. purposes but a partnership for foreign purposes), the owners were entitled to the foreign tax credit since they were liable for the tax under foreign law, though they would not have to include the income until it was distributed to them). *See also Guardian Industries, supra* note 7 (finding that Luxembourg parent corporation had sole "legal liability"—rather than joint and several liability—under the Luxembourg fiscal unity group rules for purposes of Reg.§ 1.901-2(f)(3) (2005)). *Compare* Rev. Rul. 77-209, 1977-1 CB 238 (where under a fiscal unity tax regime, the parent paid taxes but each member of the group was jointly and severally liable for the taxes of the group, the tax should be prorated among each member as if it actually paid the taxes); *Abbot Laboratories Int'l Corp.*, DC-IL, 58-1 USTC ¶9454, 160 FSupp 321, *aff'd per curiam,* CA-7, 59-2 USTC ¶9548, 267 F2d 940 (1959) (denying a foreign tax credit to a U.S. parent of reverse hybrid subsidiaries because the subsidiaries were ultimately liable for the foreign taxes, and stating *in dicta* that allowing foreign tax credits to be separated from related income is inconsistent with the purpose of the foreign tax credit).

[57] *See supra* note 6.

[58] Proposed Reg. §1.901-2(f)(1)(i) (also providing, consistently with the current regula-

tions, that "[t]his rule applies even if under foreign law another person is obligated to remit the tax, another person actually remits the tax, or foreign law permits the foreign country to proceed against another person to collect the tax in the event the tax is not paid"). The proposed regulations reserve for future guidance payments under hybrid securities (Example 3 in Part II.A above) and payments that are disregarded for U.S. tax purposes.

[59] Proposed Reg. §1.901-2(f)(2)(i).

[60] Proposed Reg. §1.901-2(f)(2)(ii).

[61] *See supra* note 56.

[62] Proposed Reg. §1.901-2(f)(2)(iii).

[63] Proposed Reg. §1.901-2(f)(6), Example 2.

[64] Reg. §1.901-2(f)(2)(ii), Example 2 (2005).

[65] In general, as a result of Code Sec. 901(l)(1)(B), the nominee or agent would also not be eligible to claim the credit because it is under an obligation to make related payments to the taxpayer.

[66] Proposed Reg. §1.901-2(f)(6), Example 3.

[67] *See* note 51 above. *See also* Rev. Rul. 72-514, discussed in note 53 above and the authorities cited therein. For a critique of the proposed regulations along similar lines, *see* Securities Industry Association, *SIA Submission in Response to Notice of Proposed Rulemaking Regarding the Definition of "Taxpayer" Under Section 901* (Oct. 5, 2006) (*available at www.sia.com/comment_letters/14874.pdf*) (the "SIA Letter").

[68] Shares of stock are typically held in "street name" (*i.e.,* the registered owner of the shares is a broker, which in turn records on its own books the name of the beneficial owner from time to time, or the name of another broker that in turn typically holds the stock in street name). Debt securities are usually issued to a clearing organization, such as The Depositary Trust Company or Euroclear, which maintains an electronic system for recording ownership interests in the name of qualified participants (*e.g.,* brokers) that in turn record the ultimate beneficial owners or other intermediaries. In addition, shares of stock of non-U.S. corporations are typically listed on stock exchanges through American Depositary Receipt (ADR) or Global Depositary Receipt (GDR) programs, in which the shares are held by a depositary that issues corresponding receipts that are listed on the stock exchange. It is not always clear under the local tax rules of a particular country whether the ADR or GDR depositary that holds the shares or the investor in the shares should be treated as the beneficial owner of the shares.

[69] These provisions are discussed in Paragraph 5 below.

[70] Consider a foreign securities dealer subsidiary of a U.S. financial institution that enters into stock or securities repo transactions in the ordinary course of business, pursuant to Code Secs. 901(k)(4) and 901(l)(2).

[71] *See* note 43 and the accompanying text, above.

[72] *See* Part VII.A below.

[73] *See NYSBA Section 1.901-2(f)(3) Report, supra* note 47, at 1023–26 (arguing that regulatory authority exists under Code Secs. 482 and 7805, and that the relevant language of the *Biddle* case, quoted in note 48 above, to the effect that a person who has no liability to pay a tax should not be treated as the taxpayer, does not support the converse proposition that a credit necessarily must be provided to the person on whom legal liability to pay the tax is laid).

[74] *See* Code Sec. 904(d) (as effective for tax years prior to January 1, 2007); Reg. §1.904-4. The nine separate limitation categories were (A) passive income; (B) high withholding tax interest (*i.e.*, interest subject to a withholding tax at a rate of five percent or more); (C) financial services income; (D) shipping income; (E) dividends from each noncontrolled Code Sec. 902 corporation (repealed in 1997); (F) non-U.S. source dividends from a DISC; (G) foreign trade income; (H) certain distributions from a FSC; and (I) general limitation (residual category).

[75] 1986 Blue Book, *supra* note 29, at 862.

[76] *See* Code Sec. 904(d)(1) (as effective for tax years beginning on or after January 1, 2007). *See* Act Sec. 404(a) of P.L. 108-357. The separate limitation categories are (A) passive income and (B) general (residual) category income.

[77] Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress 273 (2005) (the "2004 Blue Book").

[78] The implications of the Code Sec. 904 limitation for FTC arbitrage transactions involving cross-crediting is discussed further in Parts VI.B.2, VI.B.12 and VII.J below.

[79] *See* Reg. §1.861-17 (generally allocating to U.S sources a fixed percentage (25 percent or 50 percent, depending on whether taxpayer is using the optional gross income method or the sales method) of the amount incurred for research and development conducted in the United States, and allocating the remaining amount in proportion to the relative sources of gross income or total sales); Code Sec. 865(b) and Reg. §1.861-7 (utilizing the highly manipulable "passage of title, beneficial ownership and risk of loss" test to determine the source of income from inventory sales).

[80] *See* Temporary Reg. §1.861-9T (generally treating interest as a fungible item, and therefore allocating interest expense based on the relative proportion of assets producing U.S and foreign source income). Act Sec. 401(a) of P.L. 108-357 amended the interest allocation rules to permit affiliated groups to allocate interest expense on a global basis as if they were a single corporation. *See also* H.R. Rep. No. 108-548, pt. 1, at 183–84 (2004): "The present-law interest expense allocation rules result in U.S. companies allocating a portion of their U.S. interest expense against foreign-source income, even when the foreign operation has its own debt. The tax effect of this rule is that U.S. companies end up paying double tax."

[81] *See generally* Temporary Reg. §1.861-11T. In general, these rules apply to corporations that are members of an affiliated group under Code Sec. 1504 (which generally requires a common parent owning at least 80 percent of the voting power and value of at least one includible corporation, and at least 80 percent of the voting power and value of the stock of each other member being owned directly by one or more members) as well as corporations that would be includible members of an affiliated group if the test were ownership of 80 percent of the voting power *or* value of the stock, and at the IRS' discretion, disregarding trusts, partnerships and passthrough entities that break affiliated status. *See* Reg. §1.861-11(d)(1), (7), Temporary Reg. §1.861-11T(d)(6).

[82] *See* § 1.904-4(c).

[83] *See, e.g.*, the Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Income, as amended, art. 27(1)(c), U.S.-Austl., Aug. 6, 1982, CCH Tax Treaties 19,024 (2004); Convention Between the Government of the United States of America and the Government of The United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, as amended, art. 24(2), U.S.-U.K., July 24, 2001, *id.*, at 201,029–30; United States Model Income Tax Convention, art. 23A(3)(c), Sept. 20, 1996, *id.*, at 10,510.

[84] *See* the text accompanying notes 54–55 above.

[85] Code Secs. 901(k)(1) and 901(l)(1). Code Sec. 901(k) applies to withholding taxes on dividends, while Code Sec. 901(l) applies to other withholding taxes (*e.g.*, on interest or royalties). For purposes of the holding period, periods in which a taxpayer has diminished his risk of loss are not taken into account (*i.e.,* in general, periods in which a taxpayer (i) has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially identical stock or securities; (ii) is the grantor of an option to buy substantially identical stock or securities; or (iii) under regulations, has diminished his risk of loss by holding one or more other positions with respect to substantially similar or related property). *See* Code Sec. 901(k)(5) and (l)(4), adopting the rules of

Code Sec. 246(c)(3) and (4) (dealing with the dividends received deduction).

Both Code Sec. 901(k) and Code Sec. 901(l) contain an exception for withholding taxes incurred by dealers in respect of property held in the active conduct of business in a foreign country, subject to certain conditions. *See* Code Sec. 901(k)(4) and (l)(2).

[86] T.D. 9292, 71 FR 61,648 (Oct. 19, 2006).

[87] Allocations of creditable foreign taxes generally do not have substantial economic effect (assuming the parties will claim a credit rather than a deduction for the foreign taxes) because they result in a dollar-for-dollar reduction in the U.S. tax that the partner would otherwise owe and therefore the after-tax economic consequences to the partner will not be substantially diminished. *See* T.D. 9292.

[88] However, as discussed in Part VII.H below, a possible flaw in the regulation's approach to inter-branch payments may facilitate transactions designed to separate CFTEs from related income and to generate hyped credits.

[89] *See* note 1 and the accompanying text above.

[90] Improper application of the tax laws would involve an abusive tax shelter activity, and the claimed tax benefits clearly should be denied.

[91] *See* Rosenbloom, *supra* note 1, at 143. ("The beauty of international tax arbitrage, when practiced most skillfully, is that none of the objections to aggressive or abusive tax planning should apply anywhere because, from the vantage point of any single country, there is neither aggressiveness nor abuse.")

[92] *See, e.g.*, Ring, *supra* note 1, at 112–13 (arguing that in the case of double-dip leasing, while the U.S. government may have intended accelerated depreciation to serve as a subsidy for investment, when depreciation is allowed in two countries for the same asset, it may result in over-investment in that asset).

[93] *See* Avi-Yonah, *supra* note 1, at 169. Avi-Yonah argues that the single tax principle is embodied in the international tax regime that emerges from the network of over 1,500 bilateral tax treaties, and that it rests on three normative justifications: efficiency, equity and preventing revenue loss. *See id.*, at 169, 171. These considerations, along with a number of others, are examined in this Part V.

[94] Code Sec. 1503(d) and the regulations thereunder, discussed in Part VI.B.8 below.

[95] *See* Rosenbloom, *supra* note 1, at 164–65 (discussing treaties' attempts to implement the single tax principle, and some of the difficulties involved in attempting to implement the principle unilaterally); Ring, *supra* note 1, at 105 ("Given treaties' elective status for taxpayers, any support for a single tax norm from the bilateral treaty network would be more hortatory than established policy"); Kane, *supra* note 1, at 113–15 (contending that while a single tax principle is implicit in various treaty provisions, "the broader notion of a single tax principle ... cannot be defended").

[96] Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax L. Rev. 261, 294 (2001).

[97] *See, e.g.*, May, *supra* note 1 ("[d]omestic tax policy responses to unacceptable transactions therefore should be pragmatic and particular"); Ring, *supra* note 1, at 135 (advocating a balancing approach to international tax arbitrage based on several different criteria); Kane, *supra* note 1, at 139–40 (arguing that international tax arbitrage should be analyzed within a contextualized framework, based on a variety of government interests); Graetz, *supra* note 96, at 324–35 (arguing that the government should attempt to balance political and economic considerations, along with fairness, efficiency, other nations' rights, and capital import and export concerns).

[98] *See* Peggy Brewer Richman, Taxation of Foreign Investment Income, An Economic Analysis (1963); Gary C. Hufbauer, American Enterprise Institute, Hoover Institution Policy Study No. 16, A Guide to Law and Policy, U.S. Taxation of American Business Abroad (1975). *Cf. Grae*tz, *supra* note 96, at 282 ("[a]ll taxes have efficiency costs; they change incentives to engage in various activities and affect the allocation of resources"); Ring, *supra* note 1, at 103 ("[t]he efficiency inquiry in its fullest application should illuminate how cross-border tax arbitrage opportunities may impact taxpayer behavior, what distortions result, and what that should imply for government action").

[99] *See* Graetz, *supra* note 96, at 277 (advocating an approach that places the economic growth of the United States, as well as a concern for redistribution and other domestic social issues, at the forefront); Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 Tax Notes 581, 586–87 (1990) (arguing that international tax policy should be updated to take into account recent changes such as the growth of international capital markets and changes in the international capital allocation of U.S. multinational corporations); Ring, *supra* note 1, at 103 ("although the [capital export neutrality] and [capital import neutrality] constructs can be useful in orienting the efficiency analysis, they may provide too limited and constrained a conception of efficiency by highlighting particular measurements of global efficiency"); Kane, *supra* note 1, at 118–22 (describing capital export and import neutrality as "outdated" and pointing out the limitations inherent in relying solely on capital export and import neutrality as a measure of efficiency).

[100] Treasury Dep't, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study, at 23–54 (2000) (hereinafter "Treasury Subpart F Study"). ("Capital export neutrality requires structuring taxes so that they are neutral and do not cause investors to favor either domestic or foreign investment. Put another way, if taxes were structured based on capital export neutrality, investors would make their investment decisions as if there were no taxes.") For a brief description of the policy rationale behind capital export neutrality, *see* Frisch, *supra* note 99, at 582–83; Graetz, *supra* note 96, at 270.

[101] A pure application of capital export neutrality would exempt foreign income from tax in the source country altogether, but since source countries have been unwilling to forgo taxing activities by foreigners in their countries, capital export neutrality has been achieved by having the residence country grant a foreign tax credit instead of merely a deduction for such tax. Once one accepts some level of source country taxation, it is believed that capital export neutrality would most fully be achieved by granting a complete credit imposed by a particular source country for the tax against the related income from that source country, without any limitation but also without any cross-crediting (presumably under the conceptual position that each U.S.-versus-foreign-investment decision should be tested in isolation). *See* Graetz, *supra* note 96, at 271. The U.S. foreign tax credit rules, of course, do not go that far, and thus reflect a compromise between pure capital export neutrality and other considerations.

[102] Proponents of capital import neutrality argue that capital export neutrality would leave U.S. multinationals at a competitive disadvantage in low tax jurisdictions. *See, e.g.,* Michael Keen, *The Welfare Economics of Tax Coordination in the European Community, 1993 Fiscal Studies, reprinted in* Michael P. Devereux, The Economics of Tax Policy (1996); Frisch, *supra* note 99, at 583 (describing a distortion in the incentive for investment due to the limitation on the foreign tax credit, and how this impacts U.S. multinationals within a system of capital export neutrality). *Cf.* Graetz, *supra* note 96, at 273 (describing how the U.S. business community, in particular, opposes capital export neutrality, although it has also not fully supported capital import neutrality).

[103] *See id.*, at 271.

[104] *See id.*, at 272.

[105] *See id.* The Treasury has generally taken a position in favor of capital export neutrality. *See, e.g.,* Treasury Subpart F Study, *supra* note 100, at 23. Other economists have argued that the choice between capital ex-

port neutrality and capital import neutrality is essentially an empirical undertaking that must take into account the elasticities of savings and investment. *See, e.g.,* Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q.J. Econ. 793, 793–98 (1980).

[106] Ring, *supra* note 1, at 112–13.

[107] *See* Graetz *supra* note 96, at 282. ("All taxes have efficiency costs; they change incentives to engage in various activities and affect the allocation of resources.")

[108] *See* Ring, *supra* note 1, at 104, 136–38 (discussing the potential conflict between global and national efficiency); Graetz, *supra* note 96, at 277–82 (supporting a country's adoption of tax policies that benefit the national, as opposed to the global, interest).

[109] *See* 2004 Blue Book, *supra* note 77, at 273 (justifying the reduction of baskets for foreign tax credits under Code Sec. 904 as (1) reducing complexity, (2) reducing double taxation, and (3) making U.S. businesses more competitive). *See also* Graetz, *supra* note 96, at 277–82 (arguing that the United States' international tax policy should be fashioned to advance the interests of the American people rather than worldwide economic efficiency); Kane, *supra* note 1, at 119–21 (arguing that capital export and import neutrality are no longer effective means of analyzing national interest).

[110] For a general description of the equity concerns of international tax arbitrage, *see* Graetz, *supra* note 96, at 294–306 (arguing that fairness has traditionally been a concern of taxing authorities, and describing different ways that fairness can be characterized within the international tax system); Ring, *supra* note 1, at 120–23 (discussing the ability of select groups to reduce their tax burden and the effects of the perceived abuse of such arbitrage); Avi-Yonah, *supra* note 1, at 172 (characterizing the equity disparity as being between the taxation of domestic labor and that of international capital).

[111] Of course, the predicate questions of whether a particular international arbitrage transaction substantially reduces the (U.S. and/or foreign) tax burden of the U.S. participant, and the "baseline" for measuring the extent if any to which that is the case, must also be considered. *See* Paragraph 3 below.

[112] *See* text accompanying note 101 above.

[113] *See* Ring, *supra* note 1, at 122.

[114] *See id.* at 120–21.

[115] *See* Kane, *supra*, note 1, at 151–56.

[116] Code Secs. 168(g) and 168(h) (the so-called Pickle rules, providing alternative (slower) depreciation schedules for any tangible property that is used predominantly outside the United States and any tax-exempt use property (including tangible property leased to a foreign person)). *See* Act Sec. 31 of the Deficit Reduction Act of 1984 (P.L. 98-369) (1984).

[117] *See* Rev. Rul. 2002-69, 2002-2 CB 760 (taxpayer may not deduct rent and interest payments under Code Secs. 162 and 163 with respect to LILO transactions); Notice 2005-13, 2005-1 CB 630 (SILO transactions are classified as "listed" transactions, and will not be respected for purposes of Code Sec. 168). In 2004, Congress enacted Code Sec. 470, which in general disallows net losses on property used by governments or other tax-exempt entities (including foreign persons that are not subject to U.S. tax), other than pursuant to leases conforming to certain requirements. *See* Act Sec. 848 of P.L. 108-357) (2004); 2004 Blue Book, *supra* note 77, at 420 ("the Congress believed that certain ongoing leasing activity with tax-exempt entities and foreign governments indicated that the prior-law tax rules were not effective in curtailing the ability of a tax-exempt entity to transfer certain tax benefits to a taxable entity").

[118] *See* Example 7 in Part II.C above.

[119] *See* Examples 4, 5 and 6 in Part II.B above. As discussed in Part VI.B.11 below, in certain duplicate benefits FTC arbitrage transactions, the underlying investments are debt instruments of U.S. affiliates of the U.S. participant or of other U.S. issuers.

[120] *See* Paragraph 3 above and Part VI.B.7 below.

[121] *See* Graetz, *supra* note 96, at 328–31; Kane, *supra* note 1, at 129–33.

[122] *See* Graetz, *supra* note 96, at 332–35; Kane, *supra* note 1, at 122–28.

[123] *See* Notice 98-11, 1998-1 CB 433, withdrawn by Notice 98-35, 1998-2 CB 34 (advising of the future issuance of regulations to combat the use of hybrid transactions to reduce the foreign tax of a controlled foreign corporation (CFC), while simultaneously creating low-taxed, passive income that is not subject to subpart F).

[124] In 1998, the Senate recommended withdrawing Notice 98-11, and threatened to enact legislation to prevent the issuance of regulations restricting the use of hybrid transactions to reduce foreign tax liability. *See* H.R. Rep. No. 105-599, at 311–18 (1998) (Conf. Rep.). Notice 98-11 was subsequently withdrawn by Notice 98-35, 1998-2 CB 34. The Senate's proposal was not included in the final text of the bill after Notice 98-11 was withdrawn. *See generally* IRS Restructuring and Reform Act of 1998 (P.L. 105-206). In May 2006, Congress added Section 954(c)(6) to the Code, which excluded dividends and other payments between related CFCs from the category of subpart F income. *See* Act Sec. 103(b)(1) of P.L. 109-222 (2006).

[125] In its enactment of the dual consolidated loss rules of Code Sec. 1503(a), Congress appears to have been particularly troubled by the fact that the U.S. and foreign taxpayers that were obtaining the double tax benefit were in the same economic group. *See* H.R. Rep. No. 99-841, at 656–58 (1986) (Conf. Rep.). On the other hand, Congress' response to Notice 98-11 (*See* Paragraph 4.b above) indicates that the presence of related parties can be outweighed by other considerations.

[126] *See, e.g., Frank Lyon Co.*, SCt, 78-1 USTC ¶9370, 435 US 561, 567 (1978) ("Where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties"); *TIFD III-E Inc.*, CA-2, 2006-2 USTC ¶50,442, 459 F3d 220, 223 (2006), rev'g, DC-CT, 2004-2 USTC ¶50,401, 342 FSupp2d 94 (ruling that even where unrelated parties enter into a partnership, the IRS may "examine and recharacterize an interest which accords with its ostensible classification only in illusory or insignificant respects").

[127] *See*, e.g., *Aiken Industries, Inc.*, 56 TC 925 (1971) (ruling that interest payments from a U.S. company funneled through a related Honduran company to a related Bahamian company were not subject to the benefits of the U.S.-Honduras treaty since the payments were not deemed "received by" the Honduran company because the Honduran company lacked control over its use of the interest payments); *Northern Ind. Pub. Serv. Co.*, CA-7, 97-1 USTC ¶50,474, 115 F3d 506, 513 (for purposes of applying treaties, "[t]ransactions will … be disregarded if the foreign corporation lacks dominion and control over the interest payments it collects").

[128] *See Nat'l Westminster Bank, P.L.C.*, FedCl, 2004-1 USTC ¶50,105, 58 FedCl 491, 497 (2003) ("the United States Supreme Court has consistently held that the court must consider the expectations of both signatories to the treaty, not just the expectations of the U.S.").

[129] *See*, e.g., Ring, *supra* note 1, at 128 (arguing—unpersuasively in my view—"why [we should] care if a taxpayer gets a tax benefit in another country through the arbitrage, but not if the taxpayer obtains a foreign tax benefit through a different means (for example, tax rates)"); *id.,* at 162–72 (discussing the relationship between international tax arbitrage, on the one hand, and tax competition and tax harmonization, on the other).

[130] Part VII below discusses implementation and administrability considerations relevant to the FTC arbitrage transactions described in Part II.

[131] *See* Kane, *supra* note 1, at 116–38 (discussing governments' strategic interests in dealing with foreign tax arbitrage, and the interplay between the interests of multiple governments); Ring, *supra* note 1, at 59–67

(discussing the effects of tax competition, which is governments' attempts to attract foreign business or investment by modifying their tax code, and the relationship between countries' tax regimes); Graetz, *supra* note 96, at 292 (discussing potential retaliation by foreign governments in response to U.S. tax legislation); Roin, *supra* note 1, at 76 ("From any single government's point of view, it is extremely difficult to shut down such arbitrage opportunities through minor legislative 'fixes.' There are far too many inconsistencies (and ways to use them to generate benefits or fall into traps) to construct a rule for each one. Nor is the field a static one; other countries change their tax rules as frequently as we do"). However, as noted in Part VII.I below, the interdependence of U.S. and foreign rules appears to be exaggerated in the academic literature, at least when considered in the context of FTC-related arbitrage.

[132] *See generally* 1986 Blue Book, *supra* note 29, at 854– 55, 861–63.

[133] *See* Code Sec. 902(a), (c). The 1986 Act modified the relevant matching rule so as to match creditable taxes to a single post-1986 earnings pool, whereas for prior years (and for years before a foreign corporation has a 10-percent U.S. shareholder), the matching is done on a year-by-year basis. This reflects a changed perception of how to achieve a reasonable matching at a reasonable administrative cost. *See* 1986 Blue Book, *supra* note 29, at 867–68.

[134] *See* Reg. §1.904-6(a)(iv) (special rules for base and timing differences). *See* also Code Sec. 904(d)(2)(H) (as enacted in Act Sec. 404(e) of P.L. No. 108-357, generally effective for tax years beginning after December 31, 2006) (providing that taxes imposed by a foreign country on an amount that is not considered income under U.S. tax principles be placed in the general income basket, and that for the 2005–2006 tax years, taxpayers may elect to place such tax in the financial services basket or the general income basket under the old basket system).

[135] *NYSBA Section 1.901-2(f)(3) Report, supra* note 47, at 1022. It is also not helpful that FTC separation structures do not involve any unrelated parties providing nontax economic benefits that might counter-balance these troublesome aspects of such structures.

[136] Code Sec. 482 applies, inter alia, to allocations of foreign tax credits between "two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests." *See, e.g.,* Rev. Rul. 72-371, 1972-2 CB 438 (ruling that where the IRS reallocated, under Code Sec. 482, to the U.S. parent royalty income that had been paid by one foreign subsidiary to another (and that was subject to a withholding tax), the U.S. parent was entitled under Code Sec. 482 to a credit for the portion of the withholding tax that the U.S. parent would have been subject to if the royalty had been paid directly to it). *See generally NYSBA Section 1.901-2(f)(3) Report, supra* note 47, at 1023–24 (discussing the application of Code Sec. 482 in the context of foreign tax credits and FTC separation structures, and the regulatory authority that Code Sec. 482 provides for changing the technical taxpayer rule prospectively, but noting that, "[g]iven the existing regulations under Code Sec. 901 and the other authorities articulating the technical taxpayer rule, it is unclear whether the IRS could, in the absence of a regulatory amendment, apply Code Sec. 482 to require a matching between the creditable foreign tax and the related tax base in the situations under discussion").

[137] *See, e.g.,* note 79 and the accompanying text (describing sourcing rules for research and development expenses and inventory sales).

[138] Aspects of this test are discussed in Parts VII. D and E below.

[139] Letter from Mark W. Everson, Commissioner of Internal Revenue, to The Honorable Charles E. Grassley, Chairman, Senate Committee on Finance (May 19, 2006), in 2006 TNT 114-21 (June 14, 2006). *See also Compliance Concerns Relative to Large and Mid-Size Businesses: Hearing Before the S. Comm. on Finance,* 109th Cong. (June 13, 2006) (statement of Mark W. Everson, Commissioner of Internal Revenue) in 2006 TNT 114-9 (June 14, 2006) (hereinafter, "Everson Statement"). In his letter and testimony, Everson also refers to the abusive use of hybrid instruments and hybrid entities to structure international arbitrage transactions, including those involving foreign tax credits. *See also* Donald L. Korb, IRS Chief Counsel, Remarks at the George Washington University-IRS 19th Annual Institute on Current Issues in International Taxation (Dec. 15, 2006), in 2006 TNT 242-44 (describing U.S. lender transactions, U.S. borrower transactions and "asset parking transactions," all of which are discussed further in Parts VI.B.6 and VI.B.11 below) (hereinafter "Korb Remarks").

[140] Transactions involving cross-crediting similarly provide low-cost financing or an enhanced investment return, in addition to the tax benefits of interest expense and (consequently) a "hyped" foreign tax credit.

[141] *See* Letter of Mark J. Silverman & Philip R. West, Steptoe & Johnson LLP, to Hal Hicks, International Tax Counsel, U.S. Department of the Treasury, and Steve Musher, Associate Chief Counsel—International, IRS, reprinted in 2006 TNT 148-28 (July 31, 2006) (hereinafter, "Silverman-West Letter").

[142] *See* Parts II.B and III, and Paragraph 4 of Part IV, above.

[143] *See* Part IV, Paragraph 4, above.

[144] *See* Parts VII.D and E below.

[145] Also, how does one compare the degree to which leverage might be considered troublesome in the context of the foreign tax credit with the perception of leverage in other contexts, such as real estate investments or leveraged leasing?

[146] As discussed in Part VII.H below, however, in order to view hyped credit transactions as raising a policy issue concerning the proper scope of a matching principle that more closely associates the foreign tax credit with the related income, it is necessary to treat the foreign participant's share of the profits, which are derived through interest payments that are deductible for U.S. tax purposes, as attracting foreign tax credits notwithstanding that such an approach would be completely inconsistent with U.S. tax principles.

[147] Certain aspects of that test are discussed in Part VII.E below.

[148] It is curious, therefore, that the Korb Remarks (*supra* note 139), discussing three categories of "foreign tax credit generator" transactions (*see* Part VI.B.11 below), considers it troublesome that, "[i]n these structured transactions, the U.S. taxpayer claiming the credits does not bear the full economic burden of the foreign taxes paid."

[149] *See, e.g.,* Peaslee, *supra* note 50, at 83.

[150] *See* Ring, *supra* note 1, at 167–72; Rosenbloom, *supra* note 1, at 140; Roin, *supra* note 1, at 61–62.

[151] *See* text accompanying note 129, *supra.*

[152] *See, e.g., Frank Lyon Co., supra* note 126, at 577 ("the characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same"); *Thor Power Tool Co.*, SCt, 79-1 USTC ¶9139, 439 US 522, 538–44 (1979) (rejecting the argument that there is a presumption that tax accounting rules comply with generally accepted accounting principles); *D.B. Merkel*, CA-9, 99-2 USTC ¶50,848, 192 F3d 844, at 850–51 (insolvency is treated differently for bankruptcy and tax law purposes); Rev. Rul. 85-119, 1985-2 CB 60 (an instrument that was construed as equity for regulatory capital purposes was characterized as debt for tax purposes), *limited to its facts by* Notice 94-47, 1994-1 CB 357. *Cf. id.* (although treatment of an instrument as debt or equity for regulatory purposes is a relevant factor in determining its tax status, such treatment is not conclusive).

[153] The implications in this regard of the DCL rules under Code Sec. 1503(d) are discussed in Paragraph 8 below.

[154] *See, e.g.*, TAM 9748005 (Aug. 19, 1997) (in analyzing an inbound sale-and-leaseback transaction, "dual tax ownership will not be a concern in the United States when it is solely the result of differing U.S. and for-

eign legal standards of tax ownership being applied to the same facts because tax ownership is determined under U.S. legal standards without regard to the tax ownership treatment obtained under foreign law"). For a sampling of negative academic views, *see* Ring, *supra* note 1, at 110, 112–14 (describing the distortionary effects of tax arbitrage transactions, including double-dip leasing, which result in economic inefficiency); Dell'Anese, *supra* note 1, at 90–92 (citing Ring in describing the inefficiency resulting from tax arbitrage transactions, including double-dip leasing, and adding equity concerns); Shaviro, *supra* note 1, at 125 (arguing that taxpayers who engage in double-dip lease transactions are "effectively taxed nowhere on certain worldwide income. The resulting planning opportunities may have undesirable effects on taxpayer behavior and worldwide resource allocation because they violate tax neutrality, a norm that, in some circumstances, promotes efficiency").

155 *See, e.g.,* Parts V.B.3 and 4.a above.

156 *See, e.g., A.E. Schumacher*, CA-10, 91-1 USTC ¶50,224, 931 F2d 650, 652 ("The general rule in tax law is that tax credits are a matter of legislative grace, and taxpayers bear the burden of clearly showing that they are entitled to them" (citations omitted)); *Inland Steel Co.*, 230 CtCl 314, 325 (1982) ("§901 is a privilege extended by legislative grace"); *Pacific Metals Corp.*, 1 TC 1028, 1029 (1943) ("as a matter of legislative grace, the domestic tax may be offset in whole or in part by the foreign tax").

157 *See* Silverman-West letter, *supra* note 141; David H. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong in* Compaq v. Commissioner, 26 TAX NOTES INT'L 191, 195 (Apr. 15, 2002) ("Moreover, there is no principle of tax law or good sportsmanship that requires treating foreign taxes the same as domestic taxes. From the taxpayer's perspective which one they pay may be a matter of indifference. But from the U.S. perspective, we care immensely—foreign taxes are not the same as U.S. taxes").

158 *See, e.g.,* Reg. §301.7701-3(a); Reg. §1.701-2(d), Examples (1)–(4); Reg.§ 1.701-2(f), Example (3). *Cf. Helvering v. Gregory*, CA-2, 69 F2d 809, 810 (1934), *aff'd,* SCt, 35-1 USTC ¶9043, 293 US 465 (1935) ("Any one may so arrange his affairs that his taxes shall be as low as possible").

159 *See* Korb Remarks, *supra* note 139:

> One area to which we are devoting our attention is cases in which U.S. taxpayers are manipulating the Code to generate foreign tax credits under circumstances where the underlying business transaction (a financing or a portfolio investment) would not ordinarily be subject to foreign tax. ... The U.S. taxpayer benefits in these transactions by intentionally subjecting itself to foreign tax because the foreign counterparty shares the economic burden of the foreign taxes created by the structure. This is inconsistent with the purpose of the foreign tax credit to mitigate double taxation of foreign source income. In addition, it is contrary to a fundamental assumption underlying the foreign tax credit regime—that a U.S. person is indifferent as to whether it pays U.S. tax on its foreign source income or pays foreign tax on that income and claims an offsetting credit against the tax it would otherwise owe.

160 *See* Reg. §1.901-2(a)(2)(i), discussed in Part IV, Paragraph 1, above, and Part VII. C.1, below.

161 *See, e.g.,* Reg. §1.901-2(e)(5)(i) (stating, in the context of the FTC noncompulsory payment rule discussed in Part VII.C.1 below, "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 liability under foreign law for tax").

162 *See* S. REP. NO. 99-313, at 420 (1985):

> Losses that a corporation uses to offset foreign tax on income that the United States does not subject to tax should not also be used to reduce any other corporation's U.S. tax. Disallowing such losses will allow foreign and U.S. investors to compete in the U.S. economy under tax rules that put them in the same competitive position. By allowing "double dipping" (use of a deduction by two different groups), the current treatment of dual resident companies gives an undue tax advantage to certain foreign investors that make U.S. investments. The committee believes that elimination of double dipping for foreign-owned businesses will tend to put U.S.-owned and foreign-owned businesses on a competitive par. The committee does not believe that leveling the playing field for U.S.-owned and foreign-owned businesses violates any U.S. treaty obligations requiring the United States not to discriminate against foreign-owned businesses. In fact, denial of double dipping for foreign-owned businesses that operate in the United States is necessary to end U.S. discrimination against U.S.-owned businesses that operate in the United States.

163 *See id.,* at 422 (emphasis added):

> Some treaties prohibit discrimination against foreign-owned enterprises that are "similar" to U.S.-owned enterprises. The committee has crafted this provision so that it does not violate treaties. First, it is not clear that a U.S. corporation that consolidates (or otherwise shares losses) with a foreign corporation and a U.S. corporation that does not consolidate with a foreign corporation are "similar enterprises" for treaty purposes. *Second, the provision does not distinguish between corporations on the basis of their ownership, but instead on the basis of whether their losses allow foreign tax benefits to entities whose full earnings are or will be subject to U.S. tax.* Finally, it is the committee's view that this prohibition of double dipping is in fact necessary to prevent discrimination in favor of foreign-owned businesses and against U.S.-owned businesses in the U.S. economy. If the committee should be incorrect in its technical interpretation of the interaction between this provision and treaties, however, it does not intend that any contrary provision defeat its elimination of this double dipping loophole. The committee does not believe that the United States Senate wittingly agreed to an international tax system where taxpayers making cross-border investments, and only those taxpayers, could reduce or eliminate their U.S. corporate tax through self-help and gain an advantage over U.S. persons who make similar investments.

164 While the last sentence of the Senate Report discussion that is quoted in the preceding note arguably reflects such a concern, the intention and scope of that sentence appears to be highly ambiguous, particularly in light of the context in which it was expressed (*i.e.,* a rebuttal of a treaty-based discrimination argument by foreign-owned enterprises) and the last clause thereof ("gain an advantage over U.S. persons who make similar investments" (emphasis added)).

165 *See* text accompanying notes 153–55, *supra,* and Part VII.B.2, *infra*.

166 *See* May, *supra* note 1 (noting also that U.S. acquirers can similarly "double dip" on interest expense while avoiding the DCL rules); *see* also N.Y. State Bar Ass'n Tax Section, *Report on Proposed Regulations under Code Sec. 894 Regarding Payments Made by Domestic Reverse Hybrid Entities, reprinted in* 2002 TNT 10-26 (Jan. 15, 2002). This situation also is not caught under Reg. §1.894-1(d)(2)(ii)(B), which denies treaty benefits in respect of certain financing structures involving domestic reverse hybrid entities, because that provision applies only to interest payments made to a related foreign interest holder and not to unrelated lenders.

167 The Treasury and the IRS are to be commended for recently entering into a mutual agreement with the United Kingdom that will facilitate elections under the mirror rule to forgo the benefits of a deduction in one

country and to claim the deduction in the other country, *see* United Kingdom/United States Dual Consolidated Loss Competent Authority Agreement, Oct. 6, 2006 (Announcement 2006-86, IRB 2006-45, 842), but the fact that it took 17 years from the promulgation of the regulatory provision authorizing such an agreement to its implementation (*see* Reg. §1.1503-2A(c)(2), first enacted as a temporary regulation by T.D. 8261, 1989-2 CB 220, and finalized by T.D. 8434, 1992-2 CB 240) is not a good sign for other bilateral efforts to address international arbitrage situations. *See* Parts VII.B.3 and VII.I below. This election is referred to the "G-1 election" because its current regulatory authority is now found in Reg. §1.1503-2(g)(1).

[168] *See* 1986 Blue Book, *supra* note 29, at 209–10 ("taxpayers were losing faith in the Federal income tax system … [tax shelters] gave rise to a number of undesirable consequences, even aside from their effect in reducing Federal tax revenues").

[169] A general curb on complex, highly structured tax-driven transactions would, of course, present significant definitional and scope issues.

[170] Everson Statement**,** *supra* note 139.

[171] Korb Remarks, *supra* note 139.

[172] *See* Korb Remarks, *supra* note 139. ("These transactions exploit differences between U.S. and foreign law in order to permit the U.S. taxpayer to claim a credit for the foreign taxes while also allowing the foreign counterparty to claim a foreign tax benefit. These differences can encompass principles of tax ownership, timing of accrual of income, and treatment of hybrid instruments and hybrid entities.")

[173] *See* Part VI.B.6 above.

[174] Depending on the circumstances, policy arguments may exist for denying foreign tax credits if and to the extent that the U.S. participant in a U.S. lender transaction derives foreign tax credits that are attributable to funds that the non-U.S. participant invested in the joint investment entity (the "circular flows of funds" problem mentioned in the Korb Remarks quoted above), but these arguments are not particularly persuasive. The strongest case for doing so is where the joint investment entity holds debt instruments of the non-U.S. participant itself, since at least facially the circularity of the cash flows might be considered troublesome. But even in that case it is difficult to ignore the fact that the joint investment entity pays foreign tax in respect of the income that it derives from those debt instruments, so the issue reduces itself to the appropriateness of making a loan to the non-U.S. participant through a structure that was intentionally chosen in order to incur the foreign tax (*i.e.,* the same issue discussed in the text accompanying this note). Typically, however, the joint investment entity holds debt instruments of affiliates of the non-U.S. participant. In that case, absent special circumstances that would warrant recharacterizing the transaction as a direct loan to the non-U.S. participant (*cf. Plantation Patterns, Inc.*, CA-5, 72-2 USTC ¶9494, 462 F2d 712, 719–23 (recharacterizing loan to a start-up shell company that was subject to a shareholder guaranty as a loan to the shareholder), or when the affiliates are shell entities that pass the funds back to the non-U.S. participant), it does not seem appropriate to treat such investments differently from investments in third party debt instruments. And in any event, regardless of whether the joint investment entity holds debt instruments of the non-U.S. participant or of its affiliates, the fact that the U.S. participant obtained leverage from the non-U.S. participant rather than from a third party and thereby derived compensation for enabling the non-U.S. participant to enjoy non-U.S. tax benefits should not make such U.S. lender transactions more vulnerable as a policy matter than duplicate benefits FTC arbitrage transactions in which the entity holds debt instruments of unrelated third parties.

[175] Indeed, where the underlying investments are debt instruments of the U.S. participant's foreign affiliates, the result should be the same as in Example 6 of Part II.B, in which the U.S. participant obtains inexpensive financing for a non-U.S. subsidiary through a repo over the shares of the subsidiary.

[176] *See, e.g.,* the treaty provisions cited in note 83 above. As an alternative to relying on treaty sourcing rules, U.S. borrower transactions (and transactions in which the investment entity holds debt or equity instruments of unrelated U.S. issuers) may also be structured based on the interest allocation rules under the regulations under Code Sec. 861 and the Code Sec. 904 limitation.

[177] The 2004 Act renumbered Code Sec. 904(g) as Code Sec. 904(h), effective January 1, 2007. *See* Act Sec. 402(a) of P.L. 108-357.

[178] Such an approach would side-step the difficulties in revising treaty provisions, discussed in Part VII.I below, but it would not prevent self-sheltered transactions in which the joint venture entity holds debt instruments of U.S. issuers.

[179] Korb Remarks, *supra* note 139.

[180] *See, e.g.*, Reg. §1.901-2(e)(5)(i) (stating, in the context of the FTC noncompulsory payment rule discussed in Part VII.C.1 below, "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 liability under foreign law for tax").

[181] As indicated above, the Code Sec. 904(g)/904(h) approach would apply to a significantly broader class of transactions since it would curb cases in which the underlying assets were not previously owned by the U.S. participant but produce U.S. source income. On the other hand, this approach would not cover transactions that do not rely on treaties (although if and to the extent there is a perceived abuse it should be possible to curb such transactions through targeted adjustments to the Code Sec. 861 allocation and Code Sec. 904 limitation rules), nor would it cover transactions involving assets that produce foreign source income (which may reasonably be considered not to be troublesome since the taxpayer's decision to subject such assets to foreign, rather than U.S., net income tax often will have a business rationale).

[182] The regulatory authority question is discussed in Part VII.J below. The Clinton and Bush Administrations have, since 1998, repeatedly requested that Congress grant regulatory authority to the Treasury to combat tax arbitrage transactions. *See* most recently Budget of the United States Government, Fiscal Year 2007 (*available at www.whitehouse.gov/omb/budget/fy2007/pdf/spec.pdf*) ("The Administration proposes to provide the Department of Treasury with supplemental regulatory authority, in addition to its broad existing authority, to ensure that the foreign tax credit rules cannot be used to achieve inappropriate results that are not consistent with the underlying economics of the transactions in which the foreign tax credits arise. The regulatory authority would enhance the ability of the Department of Treasury to prevent the inappropriate separation of foreign taxes from the related foreign income"). To date, however, Congress has not enacted such a grant of regulatory authority. *See* most recently Jumpstart Our Business Strength (JOBS) Act, S. 1637, at §661A (2004); H.R. REP NO. 108-755, at 577–78 (2004) (Conf. Rep.). *See* also Peaslee, *supra* note 50, at 103 ("The fact that Congress legislated extensively in the area and consciously allowed cross-crediting in accordance with a highly articulated set of rules makes it very hard to justify yet another income test on top of the one Congress already devised").

[183] Proposed Reg. §1.901-2(f)(1)(i). As noted above, the proposed regulations reserve for future guidance the treatment of payments under hybrid securities (Example 3 in Part II.A above) and payments that are disregarded for U.S. tax purposes.

[184] *See* Proposed Reg. §1.901-2(f)(6), Example 4 (holding that transferee is the taxpayer with respect to the entire amount of withholding tax even though, for U.S. income tax purposes, it only recognizes interest income that accrues after the date of its purchase).

[185] *See* note 51, *supra*.

[186] *See* SIA Letter, *supra* note 67. In the event

Congress were to determine that Code Secs. 901(k) and (l) are not curbing all abusive low-risk FTC-related transactions involving withholding taxes, it could modify certain aspects of those provisions, such as extending the minimum holding period.

187 Reg. §1.701-2.

188 *See, e.g.,* William F. Nelson, *The Limits of Literalism: The Effect of Substance Over Form, Clear Reflection and Business Purpose Considerations on the Proper Interpretation of Subchapter K*, 73 TAXES 641 (1995) (arguing that the partnership anti-abuse rules exceed the traditional limits of the tax law as determined by legislation and judicial review); Letter from the Honorable Leslie B. Samuels, Assistant Secretary of the Treasury for Tax Policy, to the Honorable Robert Packwood, Chairman, Senate Finance Committee (Dec. 29, 1994) (quoted in *id.,* at 642) (arguing that the partnership anti-abuse rules reflect the traditional tax law doctrines of a business purpose requirement and that tax treatment must reflect the substance of the arrangement); David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860 (1999) (arguing that broad anti-abuse rules can promote efficiency in the tax law).

189 *See* Ring, *supra* note 1, at 141–44.

190 *See id.*

191 An optimist might hope that, were Congress to entertain such an approach, it would also reconsider the DCL rules and significantly curtail their onerous application to U.S. taxpayers while perhaps expanding their scope to reach their original intended target. *See* Part VI.B.8 above.

192 *See* note 167 above.

193 For example, the U.S. participant might have a foreign tax credit whereas a U.K. participant might have manufactured dividend benefits (*see* note 23 above).

194 *See* Reg. §1.901-2(e)(5) (describing the rules governing when a payment is considered noncompulsory, and giving examples of what constitutes compulsory and noncompulsory payments). *See also* Rev. Rul. 92-75, 1992-2 CB 197 (ruling that where the foreign subsidiary of a U.S. parent corporation failed to exhaust its available remedies to have the foreign country reduce the subsidiary's foreign income tax liability, the tax paid was noncompulsory and not creditable).

CCA 200622044 (Feb. 16, 2006) took an expansive view of the scope of the noncompulsory payments rule and applied the rule to an election under U.K. law by the taxpayer's U.K. subsidiary to use foreign dividend withholding taxes as a credit against its liability for a creditable tax rather than a noncreditable tax. *See generally* Matthew A. Stevens, *IRS Says U.K. Tax Not Compulsory, but Taxpayers Need Not Agree*, 112 TAX NOTES 1157 (Sept. 25, 2006) (arguing that CCA 200622044 is based on a strained reading of the regulation and misguided tax policy).

195 Reg. §1.901-2(e)(5)(i).

196 *See* Stevens, *supra* note 194, at 1159, note 15 ("In law and economics, moral hazard is the name given to the increased risk of problematical (immoral) behavior, and thus a negative outcome (hazard), because the person who caused the problem doesn't suffer the full (or any) consequences, or may actually benefit"). Stevens argues that a noncompulsory foreign tax is a moral hazard because the taxpayer has no incentive to expend a nominal amount to avoid paying a foreign tax (even if the foreign tax in question far exceeds the nominal amount) if the taxpayer is eligible for a full credit against its U.S. federal income tax.

197 *See* note 158 and the accompanying text above.

198 Reg. §1.901-2(e)(5)(i).

199 Code Sec. 901(i). *See also* Reg. §1.901-2(e)(3).

200 Reg. §1.901-2(e)(3)(ii) defines "subsidy" to include "any benefit conferred, directly or indirectly, by a foreign country to ... [the taxpayer, a related person or any party to the transaction, *etc.*]. Substance and not form shall govern in determining whether a subsidy exists. The fact that the U.S. taxpayer may derive no demonstrable benefit from the subsidy is irrelevant in determining whether a subsidy exists."

201 H.R. REP. NO. 99-426, at 351 (1985) (emphasis added).

202 The subsidy rules have frequently been invoked with respect to payments made by the taxing authority of Brazil to borrowers on amounts withheld from interest payments to non-Brazilian lenders. These payments have generally been characterized as rebates, and therefore are considered subsidies. *See, e.g., Norwest Corp., supra* note 51, 1409–10; *Continental Illinois Corp., supra* note 51, 519–20; Rev. Rul. 78-258, 1978-1 CB 239 (*modified on other grounds,* Rev. Rul. 89-119, 1989-2 CB 132); LTR 8718010 (Jan. 16, 1987). *See also* Reg. §1.901-2(e)(3)(iv), Examples (1) and (2) (similarly dealing with payments remitted to a borrower on amounts withheld from interest payments to foreign lenders).

203 1994 FSA Lexis 423 (June 23, 1994).

204 *Compaq Computer Corp., supra* note 55. In addition, Reg. §1.901-2(e)(4)(ii), which is part of the regulations relating to multiple levies imposed by a taxing jurisdiction, is reserved for a regulation on integrated tax systems. This implies an intent to treat integrated tax systems under the multiple levy rules rather than the subsidy rules. *See Compaq Computer Corp., supra*, 113 TC, at 374, note 8 ("the inclusion of such reserved space within the section on multiple levies instead of within the section on subsidies indicates that Treasury must also believe that such systems are closer to multiple levies than subsidies").

205 Indeed, the regulation states that "[t]he fact that the U.S. taxpayer may derive no demonstrable benefit from the subsidy is irrelevant in determining whether a subsidy exists." Reg. §1.901-2(e)(3)(ii).

206 *See* CCA 200514010 (Dec. 8, 2004), discussed in note 53 and the accompanying text above.

207 It does not appear to be easy to cure this disparity within the technical framework and policy objectives of the proposed regulation.

208 *See* Part IV, Paragraph 2, above.

209 While applying the limitation separately to each transaction might be considered overly restrictive, it would reduce the pressure to properly define the scope of covered transactions in a way that excludes passive income generators that soak up the excess credits from true FTC arbitrage transactions.

210 In terms of the consequences of a "bad" transaction, while Notice 98-5 provided for a disallowance of all foreign tax credits from such a transaction, presumably a more appropriate approach would be to disallow only the "excess" credits, or the "excess" credits above a specified level. Alternatively, Congress could provide that a transaction that is deemed to be "bad" because of the level of cross-crediting that is involved will be placed in a separate Code Sec. 904 "basket." (*See* Part VII.C.4 above.)

211 *See* notes 80–81 and the accompanying text above.

212 Notice 98-5 provides, however, that a fungibility approach applies when the taxpayer has hedged its risk from entering into a transaction.

213 Indeed, commentators identified these and other flaws of a tracing approach in criticizing Notice 98-5. *See, e.g.,* Peaslee, *supra* note 50, at 103 (giving examples of commercial transactions involving high leverage that would fail the Notice 98-5 test); David P. Hariton, *The* Compaq *Case, Notice 98-5, and Tax Shelters: The Theory Is All Wrong,* 94 TAX NOTES 501, 503–05 (Jan. 28, 2002) (illustrating how the tracing approach of Notice 98-5 can deter certain "good" transactions while failing to deter "bad" transactions).

214 Additional scope issues arise where a U.S. company sets up a deconsolidated subsidiary to engage in a transaction.

215 *See* Notice 98-5, *supra* note 16. ("Thus, under the regulations, expected economic profit will be determined without regard to executory financial contracts (e.g., a notional principal contract, forward contract, or similar instrument) that do not represent a real economic investment or potential for profit or that are not properly treated as part of the arrangement.")

216 *See id.* ("If necessary to effectuate the purposes of the regulations, a series of

related transactions or investments may be treated as a single arrangement or portions of a single transaction or investment may be treated as separate arrangements. The proper grouping of transactions and investments into arrangements will depend on all relevant facts and circumstances.")

[217] *See* Part IV, Paragraph 4, above.

[218] *See* Part VI.B.2 in the text accompanying note 145 above.

[219] There are numerous other situations in which cross-crediting arises in benign, *bona fide* commercial contexts. To cite another example, consider a bank that makes a loan to a non-U.S. borrower where the interest is subject to withholding tax, and a significant portion of the bank's interest income on the loan is offset by interest expense that is attributable to this loan (either in respect of an allocable portion of the bank's overall leverage or on a traced basis, depending on the rule that is adopted for this purpose).

[220] *See* S. REP. NO. 108-192, at 88 (2003) ("in determining pre-tax profit … foreign taxes are treated as expenses"). Over the past few years, the Senate has proposed a bill to codify the economic substance doctrine, but as of now this proposal has not been enacted. *See, e.g.,* §401 of S. 1637 (108th Cong.); S. REP. NO. 108-192, at 83 (2003). There has been a heated debate as to the wisdom and likely effectiveness of the Senate's proposed codification of the economic substance doctrine. *See, e.g.,* Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet,* 105 COLUM. L. REV. 1939 (2005) (arguing that codification would be ineffective in combating tax shelters); American Bar Association Section of Taxation, *Comments on the Proposed Codification of the Economic Substance Doctrine, reprinted in* 2003 TNT 81-74 (Apr. 28, 2003) (arguing that codification may result in an overly rigid analysis of transactions and too great a focus on vague and subjective considerations, and that well-advised taxpayers will still find a way to get around the intent of economic substance; also arguing against treating foreign taxes as an expense); New York State Bar Association Tax Section, *Treasury's Proposal to Codify the Economic Substance Doctrine,* 88 TAX NOTES 937 (2000) (arguing that the proposed codification does not adequately define abusive transactions); Symposium, *Business Purpose, Economic Substance, and Corporate Tax Shelters,* 54 SMU L. REV. (2001) (containing a variety of arguments both for and against codification).

[221] *See* Peaslee, *supra* note 50, at 100–07; Hariton, *supra* note 213, at 503–05.

[222] Notice 2004-19, *supra* note 16. Presumably, the rejection of the Notice's interpretation of the economic substance test (including the treatment of foreign taxes as expenses for this purpose) by two courts of appeals, in the *Compaq* and *IES Industries* cases, *supra* note 55, influenced the Treasury and the IRS to withdraw Notice 98-5.

[223] *ACM Partnership*, CA-3, 98-2 USTC ¶50,790, 157 F3d 231.

[224] *See ACM Partnership, id.*, 157 F3d, at 252–55. The taxpayer also must satisfy a subjective component of the economic substance test (in addition to the objective economic benefit the taxpayer realized through the transaction), which mandates that the taxpayer must have had a legitimate business purpose for entering into the transaction, aside from tax benefits, although the relationship between the objective and subjective components remains unclear. *See* S. REP. NO. 108-192, at 84–85 (2003) ("There is a lack of uniformity regarding the proper application of the economic substance doctrine. Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (*i.e.*, the subjective component) in order for the transaction to survive judicial scrutiny. A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction. A third approach regards economic substance and business purpose as 'simply more precise factors to consider' in determining whether a transaction has any practical economic effects other than the creation of tax benefits"). *See also F.C. Pasternak*, CA-6, 93-1 USTC ¶50,226, 990 F2d 893, 898 (taking the first approach); *Rice's Toyota World*, CA-4, 85-1 USTC ¶9123, 752 F2d 89, 91 - 92; *IES Industries, supra* note 55, at 353 (each taking the second approach); *ACM Partnership, supra* note 223, 157 F3d, at 247 (taking the third approach).

[225] *See, e.g.,* Hariton, *supra* note 213, at 503–05.

[226] Peaslee, *supra* note 50, at 102–03.

[227] *See id.,* at 102–05.

[228] *Id.*, at 108.

[229] *See, e.g., id.,* at 101; Hariton, *supra* note 213, at 505.

[230] *See, e.g.,* Peaslee, *supra* note 50, at 101 (noting that the *ACM Partnership* case, *supra* note 223, 73 TCM. at 2215, referred to such losses or deductions as "artificial").

[231] Consider, for example, the *bona fide* commercial situations described in note 219 and the accompanying text above.

[232] *Compaq Computer Corp.*, *supra* note 55, 277 F3d, at 785 ("If the effects of tax law, domestic or foreign, are to be accounted for when they subtract from a transaction's net cash flow, tax law effects should be counted when they add to cash flow. To be consistent, the analysis should either count all tax law effects or not count any of them. To count them only when they subtract from cash flow is to stack the deck against finding the transaction profitable"), *rev'g,* 113 TC 363 (1999); *IES Industries, supra* note 55, 253 F3d, at 354, *rev'g,* 1999 U.S. Dist. LEXIS 22610 (1999). For discussions of this issue, *see generally* Hariton, *supra* note 213, at 501–02; Shaviro & Weisbach, *supra* note 157, at 195–96; Marc D. Teitelbaum, Compaq Computer *and* IES Industries—*The Empire Strikes Back,* 86 TAX NOTES 829, 835–36 (2000).

[233] Indeed, at a minimum it would be appropriate to exclude from such a rule *bona fide* commercial transactions such as those described in note 219 and the accompanying text above, although it may be very difficult to design a rule that distinguishes between such bona fide commercial transactions and transactions that should be tested under the economic substance doctrine.

[234] *See* Part VI.B.11 above.

[235] *See* Part VI.B.5 above.

[236] Staff of the Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures,* at 182–85 (JCS-02-05) (Jan. 27, 2005).

[237] Even in the CFC context, the two principal rationales advanced by the JCT Staff for the proposal have been undercut by Congressional enactments. The Staff sought to foreclose the use of CTB entities to structure "hybrid branch arrangements" that enable a CFC to reduce foreign taxes by making deductible interest or royalty payments to a disregarded CTB entity. While the IRS had proposed and then withdrew (under Congressional pressure) regulations that sought to prevent these arrangements (*see* Notice 98-11, revoked by Notice 98-35, as noted in notes 123–24 above), the enactment of Code Sec. 954(c)(6) (*see* Act Sec. 103(b)(1) of the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) (2006)) specifically sanctions such arrangements. Similarly, the JCT Staff expressed concerns with so-called check-and-sell transactions similar to the transaction in *Dover Corp.*, 122 TC 324 (2004), but Congress has taken a benign view of the analogous case of a sale by a CFC of an interest in a partnership in which the corporation owns at least 25 percent of the capital or profits interest. *See* Code Sec. 954(c)(4), enacted by Act Sec. 412(a) of P.L. 108-357.

[238] *See* May, *supra* note 1.

[239] Reg. §1.704-1(b)(4)(viii), discussed in Part IV, Paragraph 5, above.

[240] *See, e.g.,* Reg. §1.704-1(b)(4) (viii)(c)(3)(i) ("net income in a CFTE category means the net income for U.S. Federal income tax purposes"). Consistent with the appropriate role of foreign tax law (*see* Part IV,

Paragraph 2, above) and the purpose of the regulation, the regulation properly takes account of foreign tax rules in determining the foreign tax base to which the CFTEs relate (*see* Reg. §1.704-1(b)(4)(viii)(d)).

241 Reg. §1.704-1(b)(4)(viii)(c)(3)(ii).

242 *See* New York State Bar Association Tax Section, *Report on Temporary and Proposed Regulations Concerning Allocation of Creditable Foreign Tax Expenditures* (Sept. 30, 2004), at 32–33, reprinted in 2004 Tax Notes Today 198-19 (Oct. 13, 2004) (discussing arguments on both sides of the issue).

243 While reasonable minds may differ, it would appear, however, that the deductible payment rule would not apply with respect to situations in which the deduction does not offset foreign tax liability at the partnership level (for example, where a partner is entitled to a deduction for a manufactured dividend (*see* note 23 and accompanying text above) or where the partnership pays a deductible preferred return or guaranteed payment to the U.S. participant, the benefit of which flows through to the non-U.S. participant, but a lower-tier entity (treated as a disregarded entity for U.S. tax purposes) earns income and pays full foreign tax without any reduction as a result of the deductible payment.

244 For example, it is not evident why such an approach should apply to distributions on a standard hybrid security that is treated as debt for foreign tax purposes but as equity for U.S. federal income tax purposes and that is issued by a foreign corporation or a hybrid disregarded entity.

245 *See* Reg. §1.704-1(b)(4)(viii)(d)(2).

246 *See* Reg. §1.704-1(b)(4)(viii)(d)(3).

247 *See id.; see* also Reg. §1.704-1(b)(5), Example 24.

248 *Id.*

249 *See* OECD Articles of the Model Convention with Respect to Taxes on Income and Capital, art. 23B.

250 *See, e.g.,* notes 83 and 176 and the accompanying text above.

251 *See, e.g.,* Parts VII.B.2 and 3 and VII.G above.

252 Generally, treaties are deemed to have the same status as Congressional legislation, and the later-in-time rule dictates that legislation passed after a treaty is signed overrides a conflicting treaty provision, so long as there is clear Congressional intent to do so. *See* Detlev F. Vagts, *The United States and Its Treaties: Observance and Breach*, 95 A.J.I.L. 313, 319–21; Restatement (Third) of the Foreign Relations Law of the United States, at §115 (1987). However, the ability of the Treasury and the IRS to promulgate a regulation that conflicts with an existing treaty is limited in the absence of a clear grant of regulatory authority to do so by Congress. *See Nat'l Westminster Bank, P.L.C., supra* note 128, at 497–98. On the other hand, Congress has indicated its view that, both through legislation and regulations, "[t]he United States has recognized authority to implement its tax treaties so as to avoid abuses." Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997, at 251 (1997) (reporting Congress' view that the IRS' promulgation of temporary and proposed regulations addressing the availability of treaty benefits in cases involving hybrid entities, which were subsequently authorized under Code Sec. 894(c)(2), was consistent with U.S. treaty obligations).

253 As indicated in note 167 above, the U.S.-U.K. DCL competent authority agreement was negotiated 17 years after its authorization.

254 Examples of situations in which a treaty-based solution is necessary and appropriate would include circumstances where (i) there is a specific treaty provision that needs to be modified, (ii) the treaty partners wish to deal with a class of income that avoids taxation in both countries, or (iii) there is a need to provide general guidance on the allocation of income and expenses between countries (such as the OECD transfer pricing guidelines (OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995)) or the OECD project to provide guidance for the attribution of income to permanent establishments (OECD, *Discussion Draft on the attribution of profits to permanent establishments* (2004), available at *www.oecd.org/dataoecd/22/51/33637685.pdf*).

255 *See* note 167 and the text accompanying note 192 above.

256 *See, e.g.,* Ring *supra* note 1, at 138–39; Kane, *supra* note 1, at 122–45.

257 *See* text accompanying notes 1 and 90 above.

258 *See, e.g.,* Joint International Tax Shelter Information Centre Memorandum of Understanding, Apr. 23, 2004, available at *www.irs.gov/pub/irs-utl/jitsic-finalmou.pdf* (creating a joint task force, comprising the United States, Australia, Canada and the United Kingdom, to combat international tax arbitrage). *See* also OECD Forum on Tax Administration, Seoul Declaration (Sept. 14-15, 2006), available at *www.oecd.org/dataoecd/38/29/37415572.pdf* (advocating international cooperation to combat non-compliance with national tax laws); Everson Statement, *supra* note 139 ("[d]ue to the global aspects of [abusive foreign tax credit transactions], we must consider tools available under international treaties and exchange of information agreements").

259 Code Sec. 7805(a).

260 *See* note 182 above.

261 *See* notes 222 and 232 and the accompanying text above.