

STEPTOE & JOHNSON^{LLP}

ATTORNEYS AT LAW

Mark J. Silverman
202.429.6450
msilverm@steptoe.com

Philip R. West
202.429.6247
pwest@steptoe.com

1330 Connecticut Avenue, NW
Washington, DC 20036-1795
Tel 202.429.3000
Fax 202.429.3902
steptoe.com

July 31, 2006

Via PDF file and First Class Mail

Hal Hicks
International Tax Counsel
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW, Room 3054
Washington, DC 20220

Steve Musher
Associate Chief Counsel – International
Internal Revenue Service
CC:INTL Room 4554
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Hal and Steve:

Thank you for agreeing to meet with us concerning certain transactions that involve leveraged foreign investment and cross-border tax arbitrage. We requested this meeting because several developments have significantly increased the level of uncertainty among taxpayers and their advisors regarding the view of the IRS and Treasury on these relatively common transactions. The developments include public statements by both IRS and Treasury officials on the subject,¹ publicity in the domestic and

¹ See *A Tune-up On Corporate Tax Issues: What is Going On Under the Hood?: Hearing Before Senate Committee on Finance, 109th Cong.* (June 13, 2006) (Statement of Mark Everson, Commissioner of Internal Revenue); Lee A. Sheppard, *Tax Officials Brief Bankers on Cross Border Banking Questions*, 2006 TNT 21-4 (June 23, 2006); Lee A. Sheppard, *Treasury Officials Brief NYSBA on International Issues*, 2006 TNT 17-5 (January 26, 2006), Sheryl Stratton, *Tax Arbitrage Not Inherently "Evil," Treasury Official Says*, 2006 TNT 9-3 (January 13, 2006); Robert Goulder, *Treasury Official Questions U.K. Antiavoidance Approach*, 2005 TNT 98-7, (May 23, 2005); Lee A. Sheppard, *IRS's Hicks Comments on Current Problems, Projects*, 2005 TNT 82-4 (April 29, 2005).

Hal Hicks and Steve Musher
July 31, 2006
Page 2

foreign press,² the withdrawal in 2004 of Notice 98-5,³ and unresolved audits of several taxpayers engaged in these transactions.⁴ We also note that recent Senate Finance Committee hearings on the nominations of Treasury Secretary Paulson and Assistant Secretary-designate Solomon have focused in part on the “tax gap,” perhaps causing additional attention to be paid to transactions in which foreign tax credits are claimed.⁵

At the outset, we would like to make clear that we do not represent in this matter any taxpayers that have or have had these transactions under audit by the IRS. Nor do we represent promoters of these transactions, and we have not delivered opinions on their viability. Numerous taxpayers are, however, considering and/or may in the future consider entering into these transactions. Those taxpayers have a strong interest in opening a dialogue with the government with a view to establishing, if possible, a mutually agreed view of these transactions and ensuring that any forthcoming guidance draws appropriate lines and is as clear as possible regarding which aspects of the transactions, if any, violate applicable rules and standards.

² See Carrick Mellenkamp and Glenn R. Simpson, *How a U.K. Banker Helps U.S. Clients Trim Their Taxes*, WALL STREET JOURNAL, June 30, 2006, at A1; Lee A. Sheppard, *News Analysis: Banks' Foreign Tax Credit Arbitrage*, 2006 TNT 137-4 (July 9, 2006). See also Ian Kerr, *BarCap's Secret Weapon*, EUROMONEY INSTITUTIONAL INVESTOR, March 24, 2006, at 20; Peter Thal Larsen, *Sprinter's Dash For Tax Advantages Has Admirers Watching in the Stands*, FINANCIAL TIMES, March 15, 2006, at 21.

³ See Notice 2004-19, 2004-1 C.B. 606. The withdrawal of Notice 98-5 and the IRS' simultaneous decision that the transactions described therein would no longer be listed transactions, coupled with simultaneous public statements from Treasury officials about a continuing concern with abusive foreign tax credit transactions (see Robert Goulder, *Angus Voices Concern Over Foreign Tax Credit Regime*, 2004 TNT 54-6 (March 24, 2004); Christopher Netram, *Foreign Tax Credit Regs Out Soon, Treasury Official Says*, 2004 TNT 74-4 (April 15, 2004)), sent somewhat ambiguous and perhaps inconsistent messages in this area. Moreover, although the withdrawal of Notice 98-5 in a number of ways eased concerns about how the government would treat these transactions, it also in some ways increased the uncertainty surrounding the question of what standards the government would use to assess them.

⁴ We understand that several taxpayers have these transactions under audit and that the national office is deeply involved in the direction of these audits, but that a number of the audits are not being resolved as quickly as anticipated.

⁵ See *Nomination of Mr. Henry Paulson, Jr. to be Secretary of the Treasury, U.S. Department of the Treasury: Hearing before the Senate Committee on Finance*, 109th Cong. (June 23, 2006) (Statement of Henry Paulson, Jr.)(Tax Analysts pp. 44-45); Press Release, Senator Max Baucus, Nominee for Tax Policy Post at Treasury Department Pressed on Tax Shelters at Hearing (July 13, 2006).

Hal Hicks and Steve Musher
July 31, 2006
Page 3

Toward that end, this letter briefly describes a series of transactions that can be viewed as points on a spectrum of tax sensitivity. The objective of this presentation is to help reveal the features of the transactions that may be viewed as problematic, thereby also helping to highlight the features that are not. The letter's conclusion summarizes what we might take away from an examination of these examples and discusses important issues relating to what, if anything, should be done about any concerns that might exist.

EXAMPLES

1. Example 1: Base Case

Assume that a United States Person ("USP") is contemplating an investment, and is considering making that investment in one of three places: Country X, the United States, or Country Y. Assume further that the tax rates in these locations are 40%, 35%, and 30% respectively, that the investment will be in branch form, and that the investment generates \$100 of income per annum before taxes. Locating the investment in Country X would require USP to pay 40 in tax, all to Country X. Locating the investment in the United States would require USP to pay 35 in tax, all to the United States. Locating the investment in Country Y would require USP to pay 35 in tax, 5 to the United States and 30 to Country Y.

USP determines that it is preferable to invest in Country Y, and invests there. We assume that the transaction is not problematic, despite the fact that the choice of location effectively means that the United States collects 30 less in tax revenue (due to the foreign tax credit) than would be the case if the investment were made in the United States.

2. Example 2: Cross Crediting

Assume that USP determines that it is preferable to invest in Country X and invests there. Assume further that USP uses 35 of its 40 of foreign tax credits to eliminate the 35 of tax that otherwise would be imposed by the United States on the income from the investment, and uses 5 of its 40 of foreign tax credits to eliminate the U.S. tax on other unrelated foreign source income in the same basket as the income from the investment. We assume agreement that all 40 of the credits are allowable.

3. Example 3: U.S. Tax Reduction through Deferral

Assume the same facts as in Example 1, but that the investment is made in subsidiary form and constitutes an active business that does not generate subpart F income. Assume further that the reason the investment is made in Country Y is solely because the after-tax return is better there, due to the deferral of the \$5 of residual U.S. tax available because of the decision to invest in Country Y and to do so in subsidiary form. We assume agreement that the result is the same as in Example 1.

Hal Hicks and Steve Musher
July 31, 2006
Page 4

4. Example 4: Foreign Investment Decision Based on Foreign Partner's Intangibles

Assume the same facts as in Example 1, but also assume that USP's pre-tax return is better in Country Y than it would be in either Country X or the United States because it is joining with a Country Y partner who brings to the venture knowledge of the local market that USP does not have, making the business more profitable if conducted in Country Y with the partner's expertise than if conducted in the United States without it. We assume agreement that the result is the same as in Example 1. We also assume agreement that the result would be the same even if a U.S. partner could provide a similar benefit.

5. Example 5: Foreign Investment Decision Based on Foreign Partner's Capital

Assume the same facts as in Example 1, but also assume that USP's pre-tax return is better in Country Y because it is joining with a Country Y partner who is able to provide capital, increasing the size of the venture, allowing it to achieve critical mass that will enhance its profitability. We assume agreement that the result is the same as in Example 1.

6. Example 6: Foreign Investment Decision Based on Foreign Partner Increasing the Return to USP Because of Additional Revenue Generated in Other Businesses

Assume the same facts as in Example 1, but also assume that USP's pre-tax return is better in Country Y because it is joining with a Country Y partner who can use the intangible value of a partnership with USP to create or enhance other unrelated business opportunities in Country Y and therefore is willing to provide USP with a marginally but materially disproportionate return on its partnership investment. We assume agreement that the result is the same as in Example 1.

7. Example 7: Foreign Investment Decision Based on Foreign Partner Increasing the Return to USP Because of Additional Revenue Generated Through a Local Tax Benefit – Operating Business

Assume that USP has a subsidiary in Country Z, and that it is able to refinance its investment in its subsidiary at a financing rate that is marginally but materially better than the rate it is paying to finance its Country Z subsidiary currently. Assume it is able to do this by investing through Country Y in a transaction in which a Country Y partner supplies this favorably priced financing through a structure that is subject to tax in Country Y. As such, the subsidiary is no longer financed with a loan producing interest that is deductible in Country Z but taxable in the United States. Now, it is financed with a loan that is deductible in Country Z but taxable in Country Y, with the Country Y tax being creditable by USP in the United States. Assume that the financing rate is better in this structure because USP is joining with a Country Y partner. The Country Y partner is willing to provide USP with a marginally but materially disproportionate return on its investment (through more favorable financing) not because the partner can create or enhance other unrelated business opportunities in Country Y, as in Example 6, but because it is able to reduce its effective tax rate in Country Y through the structure of the investment with USP. We believe that these are the essential facts of the transactions currently being considered by taxpayers and being reviewed by the IRS, and we believe that, without more, there is no rule of law or standard that produces in this example a result different from that in Example 1.

Hal Hicks and Steve Musher
July 31, 2006
Page 5

8. Example 8: Foreign Investment Decision Based on Foreign Partner Increasing the Return to USP Because of Additional Revenue Generated Through a Local Tax Benefit – Investment Portfolio

Now consider Example 7 and Example 1 together, except that the investment is a portfolio of foreign financial assets. Assume further that USP's pre-tax return is better in Country Y because it is joining with a Country Y partner who is willing to provide USP with a marginally but materially disproportionate return on its partnership investment because it is able to reduce its effective tax rate in Country Y through the investment with USP. We believe that these also are the essential facts of the transactions at issue, and believe that, without more, there is no rule of law or standard that produces in this example a result different from that in Example 1.

It appears, however, that this example, and perhaps the preceding example, raise questions in the minds of some government officials about whether U.S. tax benefits are being impermissibly claimed. We believe it is important to clarify that the ability of the partner to reduce its effective tax rate through this investment, at the same time that USP is claiming the foreign tax credit to which it is entitled, is not what the government finds offensive about this transaction. To help clarify that point, it may be useful to examine several other "arbitrage" transactions.

9. Example 9: OID Arbitrage

Assume that USP is in need of financing and issues a bond to investors in Country Z. Country Z does not have OID rules, so a zero coupon bond allows a holder to defer the inclusion of income, while the U.S. issuer deducts the interest on an economic accrual basis. Because of the absence of OID rules in Country Z, the bonds can be issued at a lower rate of interest than if they were issued in the United States. We assume agreement that the interest deductions are allowed to USP.

10. Example 10: Debt/Equity Arbitrage – U.S. Issuer Debt Treatment

Assume the same facts as in the preceding example, but Country Z treats the instrument as equity, so exempts from tax the income to the holder of the instrument under its exemption system. We assume agreement that interest deductions are allowed.

11. Example 11: Debt/Equity Arbitrage – U.S. Holder Equity Treatment Generates Foreign Tax Credits

Assume the same facts as in the preceding example, but the issuer is in Country Z, which treats the instrument as debt, and the holder is in the United States, which treats the instrument as equity. The U.S. holder claims an indirect foreign tax credit for Country Z taxes paid by the issuer. We assume agreement that the foreign tax credits are allowed.

Hal Hicks and Steve Musher
July 31, 2006
Page 6

12. Example 12: Stripped Bond Arbitrage

Assume that USP is in need of financing and issues a financial instrument to investors in Country Z. Assume that the instrument is a stripped bond that consists of an interest-only piece (the stripped coupons) and a principal piece. Assume that Country Z allows its residents to hold their coupons offshore and avoid paying tax on the income as it accrues, allowing USP to pay a lower rate of interest than it would if it issued the instrument in the United States. Assume further that Country Z does not have rules similar to those in section 1286, so that when USP (or a disregarded affiliate) sells the interest-only piece to Country Z investors, it is subject to foreign tax on the full amount realized immediately upon the sale, whereas for U.S. tax purposes, it accrues income offsetting its interest deductions over time as those deductions otherwise would accrue. Even though the income is included over time for U.S. tax purposes whereas the foreign tax is paid immediately on sale of the interest-only piece, we know of no rule of law or standard that requires foreign tax credits to accrue at a rate no greater than the U.S. tax on the includable income that carries the foreign tax credits, and assume agreement on the conclusion that the foreign tax credits are allowed.

13. Examples 13(a), 13(b), and 13(c): Variations Provide Cause for Concern?

Let us now revisit Example 8. It seems clear in light of the subsequent examples that “arbitrage” itself is not the offending feature of Example 8 or variations thereon. Even Notice 98-5, perhaps the high water mark of government action against foreign tax credit transactions, did not condemn a transaction because it involved arbitrage. Rather, Notice 98-5 used arbitrage as a “filter” to sort out transactions that would need to be tested under a “tax-benefits-to-economic-return” test (the “economic return” test) from those that would not. It was the economic return test that condemned or acquitted the foreign tax credit transactions. The arbitrage filter merely served to narrow the scope of transactions to which that test would be subject under the notice.⁶ With that in mind, it would be useful to examine some real-world variations on the transaction described in Example 8 that have appeared in the market.

⁶ Notice 98-5 attempted to set forth a standard by which the economic substance of these transactions would be judged. Although its economic return test was criticized as being difficult to apply conceptually to a financing transaction, most of the transactions with the basic features of Examples 7 and 8 above that take place in the market are well within what most practitioners believe to be a reasonable interpretation of the economic profit test described in the notice. This suggests one of several things: (1) new standards are being considered for foreign tax credit arbitrage transactions that are even more stringent than those of Notice 98-5, despite the fact that the Notice was withdrawn and the transactions described therein de-listed, (2) even though the notice standards might have been met, the transactions are troubling to the government for other reasons, including perhaps the subjective prong of the economic substance test, the non-compulsory payment rule (see reg. sec. 1.901-2(e)(5)), or some other rule or standard, or (3) taxpayers and their advisors misconstrued Notice 98-5 and adopted standards that were not stringent enough. See the conclusion below for further discussion of this point.

Hal Hicks and Steve Musher
July 31, 2006
Page 7

a) Assets Generate Foreign Source Income Only Through Treaty Re-sourcing

Assume the same facts as in Example 8, except that the investment is a U.S. asset. Assume further that USP would not be able to use credits for any foreign taxes due on income from the investment because of inadequate capacity under section 904. Assume, however, that, as part of the transaction, the assets are deemed to generate foreign source income due to the re-sourcing rule of the treaty between the United States and Country Y. We believe that the use of the treaty in this manner may be of legitimate concern to the government.

b) Credits are "Hyped" Through Permanent Mismatch of Income and Credits

As discussed above in connection with Example 12, there is no rule of law or standard that requires foreign tax credits to accrue at a rate no greater than the U.S. tax on the includable income that carries the foreign tax credits. Notwithstanding this aspect of the law today, it would be reasonable for the government to have concerns with a transaction in which foreign taxes were generated on income that would never be taxed for U.S. purposes. (This is to be distinguished from a case like that depicted in Example 10, involving only a timing difference and not a base difference.) Although such a situation is specifically contemplated by the foreign tax credit regulations (see Reg. sec. 1.904-6(a)(1)(iv)), it nevertheless would be reasonable to have concerns with a transaction structured to provide double tax relief on income that will never be subject to double tax, that is, where the result is not specifically contemplated by the statutory scheme (see, e.g., Code sections 304, 338, etc.).

c) Partner/Lender is Issuer of Investments

Assume the same facts as in Example 8, but that the investment is a pool of financial assets consisting in whole or in part of obligations issued by the Country Y partner. The circularity may suggest that the Country Y partner has no interest at risk in the investment, at least to the extent it consists of Country Y partner obligations, and it may be appropriate to recharacterize the transaction. This situation should be distinguished from one in which the Country Y participant is a bona fide lender whose loan is secured through a security interest in the investment that is granted on commercially reasonable terms.

CONCLUSION

As illustrated by the preceding examples, we think there is no serious debate about the fundamental proposition that, absent a law or regulation to the contrary, a tax result is not rendered inapplicable solely because a different or inconsistent result is produced for the same transaction under the laws of a foreign jurisdiction.⁷ Moreover, we think there is no serious debate about the fundamental proposition

⁷ See PLR 9748005 (Aug. 19, 1997); Philip R. West, *Foreign Law in U.S. International Taxation: The Search for Standards*, 3 Florida Tax Review 147 (1996).

Hal Hicks and Steve Musher
July 31, 2006
Page 8

that an enhanced economic return or the prospect of a lower cost of funding before consideration of U.S. taxes constitutes a valid business purpose for adopting a particular structure for a given investment. Taken together, these two propositions suggest that, if a U.S. taxpayer is able to obtain capital through a structure at a lower cost of funds than would be paid without that structure, the tax consequences that otherwise result under that structure are not rendered inapplicable, even if the structure yields inconsistent tax results in the United States and another jurisdiction, unless some other feature of the transaction violates some controlling rule or standard. We suggest several such features in Examples 13(a)-13(c) above. It is possible, however, that the government has other concerns.

1. U.S. Subsidy

It has been suggested that the main concern of the government may be that the reduced financing costs in these transactions in effect represent a subsidy from the U.S. fisc in the form of enhanced foreign tax credits. Such a subsidy cannot be said to exist, however, if the transaction is not one in which foreign tax credits are "hyped." That is, no subsidy can be said to be provided by tax benefits if the taxpayer is including in income an amount of income subject to foreign tax that is appropriate to the credit. Put another way, no subsidy exists in transactions that do not generate excess foreign tax credits. Therefore, if the government objection is based on this "subsidy" concern, it should not apply to any transactions in which there are little or no excess foreign tax credits generated. That being said, as pointed out in Example 2 above, the mere existence of excess foreign tax credits is not by itself problematic. As such, it seems that if the government is to have a concern with excess foreign tax credits generated in these transactions, it must be that the transactions contain an additional feature that is of concern.

2. Voluntary Tax

It has been suggested that what may be at the root of the government's concern is the voluntary act of entering into a transaction that generates foreign tax credits. Obviously, however, if this is the concern, the government must have a basis for distinguishing these transactions from the many non-objectionable voluntary decisions to engage in activities or acquire investments that are subject to foreign tax.

One possibility is that the government believes that these transactions violate the noncompulsory payment rules of regulations section 1.901-2(e)(5). Those rules, however, have not historically been viewed as having been violated by a voluntary decision to enter into a business or make an investment that is subject to a generally applicable foreign tax, but rather by actions or omissions that increase or fail to decrease a foreign tax the imposition of which is variable as applied to a given business or investment. To our knowledge, there is no flexibility or variability with respect to the foreign taxes imposed on the businesses and investments at issue in the transactions under consideration. And we do not believe that the non-compulsory payment rules can be practically administered if they are to turn on the decision to enter into the business or make the investment, as opposed to the ability to decrease the tax once the business or investment is decided upon. Put another way, if the noncompulsory payment rules were to be interpreted that way, they would amount to no more than a regulatory business purpose test.

Hal Hicks and Steve Musher
July 31, 2006
Page 9

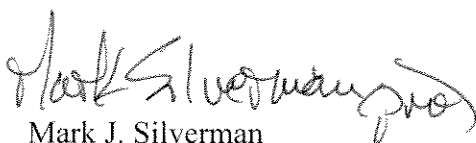
3. Business Purpose

The business purpose doctrine is an element of the economic substance doctrine and, in many circuits, must be established irrespective of whether the transaction has objective economic profit potential.⁹ As such, the Service is entitled to put taxpayers to their proof on the business purpose issue. It is respectfully submitted, however, that if the viability of these transactions turns on their business purpose, the issue is not one well suited to the issuance of guidance. Rather, the Service should examine the transactions about which it has business purpose concerns and, if the taxpayers and the exam team cannot reach agreement on the point, the issue should be dealt with at appeals and, if necessary, litigated.

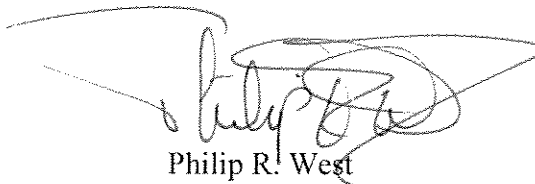
If business purpose is the root of the Service's concerns, and because this is a highly factual issue best suited to resolution through the audit and examination process, we respectfully submit that the Service need issue no new guidance aimed at these transactions. To the extent that the Service's concerns go beyond business purpose, we respectfully submit that an effective way to attack these transactions would involve a change in the controlling law.¹⁰ Finally, we respectfully request that, if guidance is issued with respect to these transactions, the guidance be clear that it is one of the three features of the transactions described in Examples 13(a)-(c) above, and not other features such as the inconsistent tax treatment of the transactions across borders, that renders the transactions troubling to the government.

We appreciate your time and attention to this matter, and look forward to our meeting and to continuing our dialogue with you on this important issue.

Sincerely yours,



Mark J. Silverman



Philip R. West

⁹ See, e.g., *Deweese v. Commissioner*, 870 F.2d 21 (1st Cir. 1989); *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988); *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); *United Parcel Service of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001). For examples of cases in which business purpose need not be proven if objective economic profit potential is proven, see, e.g., *DeMartino v. Commissioner*, 862 F.2d 400 (2d. Cir. 1988); *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992). Authority in the Federal Circuit was consistent with this disjunctive version of the test (see *Johnson v. United States (Johnson II)*, 32 Fed. Cl. 709 (Cl. Ct. 1995), *aff'd sub nom*, *Drobny v. United States*, 96-1 USTC ¶ 50,255 (Fed. Cir. 1996)), but see *Coltec Industries, Inc. v. United States*, 2006 WL 1897077, 2006-2 USTC P 50,389 (Fed.Cir. Jul 12, 2006) (NO. 05-5111).

¹⁰ Obviously, such a change would be prospective.