[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9535]

RIN 1545-BK25

Determining the Amount of Taxes Paid for Purposes of the Foreign Tax Credit

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations providing guidance relating to the determination of the amount of taxes paid for purposes of the foreign tax credit. These regulations address certain highly structured transactions that produce inappropriate foreign tax credit results. The regulations affect individuals and corporations that claim direct and indirect foreign tax credits.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Date: For dates of applicability, see §1.901-1(j) and §1.901-2(h)(2).

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SUPPLEMENTARY INFORMATION:

Background

On March 30, 2007, the **Federal Register** published proposed regulations (72 FR 15081) under section 901 of the Internal Revenue Code ("Code") relating to the amount of taxes paid for purposes of the foreign tax credit (the "2007 proposed

regulations"). The IRS and the Treasury Department received written comments on the 2007 proposed regulations and a public hearing was held on July 30, 2007. In response to written comments, the IRS and the Treasury Department issued Notice 2007-95 (2007-2 CB 1091 (December 3, 2007)) (see §601.601(d)(2)(ii)(b)) providing that the proposed rule for U.S.-owned foreign groups would be severed from the portion of the 2007 proposed regulations addressing the treatment of foreign payments attributable to certain structured passive investment arrangements. On July 16, 2008, a notice of proposed rulemaking by cross-reference to temporary regulations and temporary regulations (TD 9416) (the "2008 temporary regulations") were published in the **Federal Register** at 73 FR 40792 and 73 FR 40727, respectively. Corrections to those temporary regulations were published on November 14, 2008, in the **Federal Register** (73 FR 67387). The 2008 temporary regulations address the treatment of foreign payments attributable to structured passive investment arrangements and do not address the treatment of U.S.-owned foreign groups.

The IRS and the Treasury Department received written comments on the 2008 temporary regulations, which are discussed in this preamble. All comments are available at www.regulations.gov or upon request. A public hearing was not requested and none was held. This Treasury decision adopts the proposed regulation with the changes discussed in this preamble.

Summary of Comments and Explanation of Revisions

A. Treatment of Amounts Attributable to a Structured Passive Investment Arrangement

These final regulations retain the basic approach and structure of the 2008 temporary regulations. Thus, the final regulations provide that amounts paid to a foreign taxing authority that are attributable to a structured passive investment arrangement are not treated as an amount of tax paid for purposes of the foreign tax credit. An arrangement that satisfies six conditions, as described in this preamble, is treated as a structured passive investment arrangement.

A comment presented several proposals that collectively would have required further differentiation both among the various investors in structured passive investment arrangements based upon their business practices and relationships to other parties, as well as among the particular transactions undertaken by a special purpose vehicle involved in the arrangement. Because the IRS and the Treasury Department believe these proposals would introduce several subjective and factually-intensive elements into the regulations that would increase administrative burdens for taxpayers and the IRS, including a rule providing for only partial disallowance of foreign tax credits, the final regulations retain the approach of the 2008 temporary regulations, relying on objective, generally applicable standards to the extent possible. The IRS and the Treasury Department believe that this approach will appropriately disallow any foreign tax credits arising from artificial structures that are utilized to generate foreign tax credits and material duplicative foreign tax benefits.

B. Structured Passive Investment Arrangements

A comment recommended adding a requirement that the 2008 temporary regulations' six conditions be fulfilled as part of a plan or series of related transactions. The IRS and the Treasury Department did not adopt this comment. The standard in the

regulations is designed to depend upon key objective aspects of an arrangement that indicate an abusive arrangement. The IRS and the Treasury Department believe that the introduction of a plan requirement or similar rule would introduce a subjective inquiry that is difficult to apply and unnecessary to achieve the purpose of the regulations.

C. Section 1.901-2(e)(5)(iv)(B)(1): Special Purpose Vehicle

The first condition provided in §1.901-2T(e)(5)(iv)(B)(1) of the 2008 temporary regulations is that the arrangement utilizes an entity that meets two requirements (the "SPV condition"). The first requirement is that substantially all of the entity's gross income, as determined under U.S. tax principles, is attributable to passive investment income and substantially all of the entity's assets are held to produce such passive investment income. The term entity, as defined in §1.901-2T(e)(5)(iv)(C)(3) of the 2008 temporary regulations, includes a corporation, trust, partnership, or disregarded entity. For purposes of the first requirement, §1.901-2T(e)(5)(iv)(C)(5) of the 2008 temporary regulations defines passive investment income as income defined in section 954(c) with certain modifications. Passive investment income generally includes the income of an upper-tier entity attributable to its equity interest in a lower-tier entity, but such income may be excluded from passive investment income where it is attributable to a qualified equity interest in certain lower-tier entities that are engaged in an active trade or business and other conditions apply (the "holding company exception"). See §1.901-2T(e)(5)(iv)(c)(5)(ii).

One comment recommended that the definition of passive investment income be modified to exclude personal service contract income as described in section 954(c)(1)(H) because such income is not derived from passive assets and would not

ordinarily be used in a structured passive investment arrangement. The IRS and the Treasury Department agree with the comment, and accordingly these final regulations provide that passive investment income does not include personal service contract income as described in section 954(c)(1)(H).

The IRS and the Treasury Department also received several comments regarding the holding company exception. One comment recommended that the definition of passive investment income exclude income attributable to equity interests in pass-through entities except to the extent that the income of the lower-tier entity satisfies the definition of passive investment income. The IRS and the Treasury Department did not adopt this proposal because the IRS and the Treasury Department believe that the rule in the 2008 temporary regulations is necessary to prevent taxpayers from using pass-through entities to avoid the limitations on the holding company exception, such as the holding of qualified equity interests and the sharing of investment risk. The interests in a pass-through entity can be substantially indistinguishable from interests in a corporate subsidiary, and, therefore, these final regulations treat such interests the same for purposes of the definition of passive investment income. The final regulations clarify that income attributable to equity interests in pass-through entities (including a partner's distributive share of partnership income and the income attributable to an entity disregarded for U.S. tax purposes) is treated as passive investment income unless the holding company exception applies.

The IRS and the Treasury Department have deleted the last two sentences in the 2008 temporary regulations in §1.901-2T(e)(5)(iv)(B)(1)(i). These sentences described rules set out in more detail in the definition of passive investment income. The IRS and

the Treasury Department believe that these sentences did not provide additional clarity to the definition of passive investment income.

One comment recommended expanding the holding company exception to treat income attributable to certain portfolio interests as active income if the income earned by the lower-tier entity was active income. As a condition to the application of the holding company exception, the potential holding company's equity interest in the lower-tier entity must be a qualified equity interest. The holding company exception focuses on whether a joint venture arrangement conducted through a holding company structure economically replicates the interests of the joint venturers in the active business of the lower-tier entity. It is not intended to insulate portfolio investments in lower-tier entities even if they operate active businesses. Therefore, the IRS and the Treasury Department do not believe that it is appropriate to broaden the holding company exception to apply to portfolio investments notwithstanding that in certain cases the lower-tier entity may have active operations.

Another comment recommended that the holding company exception be replaced with a rule that generally attributes all activities of lower-tier entities to their owners, subject to an anti-abuse exception. Under the suggested anti-abuse rule, the attribution rule would not apply if, with a view to avoiding the SPV condition, a holding company holds assets other than stock in subsidiaries, and, based on all the facts and circumstances, the ownership of those assets is expected to achieve substantially the same effect as holding those assets in a separate entity. A similar comment was considered and not adopted during the promulgation of the 2008 temporary regulations. The IRS and the Treasury Department believe that the commentator's recommendation

would be difficult to administer because it would require factually intensive and subjective determinations. Therefore, this comment was not adopted.

Additionally, comments recommended clarifying the requirement in the holding company exception that substantially all of a potential holding company's opportunity for gain and risk of loss with respect to its qualified equity interest in a lower-tier entity be shared by the U.S. party or parties (or persons that are related to a U.S. party) and a counterparty or counterparties (or persons that are related to a counterparty). According to the comments, there are common situations where it is not clear that gain and risk of loss are shared, including preferred stock and stock-based compensation. The IRS and the Treasury Department believe that existing legal principles should apply to determine if an interest holder possesses the opportunity for gain and risk of loss and that additional guidance is generally unnecessary. The IRS and the Treasury Department further believe that the sharing of gain and risk of loss is dependent on facts and circumstances and therefore the final regulations provide that the assessment of opportunity for gain and risk of loss is based on all facts and circumstances.

Finally, comments requested clarification regarding the application of the holding company exception to fact patterns involving multiple counterparties or multiple U.S. parties. In response to the comments, these final regulations clarify that in cases involving more than one U.S. party or more than one counterparty or both, the requirement that the parties must share in substantially all of the upper-tier entity's opportunity for gain and risk of loss with respect to its interest in a lower-tier entity is applied by examining whether there is sufficient risk sharing by each of the groups comprising all U.S. parties (or person related to such U.S. parties) and all counterparties

(or persons related to such counterparties). The IRS and the Treasury Department believe that the risk sharing requirement, as so modified, will continue to ensure that only bona fide joint ventures are eligible for the holding company exception. If there is more than one U.S. party or more than one counterparty, the final regulations do not require that each member of the U.S. party and counterparty groups share in the underlying investment risk. Finally, the holding company exception has been modified to provide that where a U.S. party owns an interest in an entity indirectly through a chain of entities, the exception is applied beginning with the lowest-tier entity in the chain before proceeding upward and the opportunity for gain and risk of loss borne by any upper-tier entity in the chain that is a counterparty is disregarded to the extent borne indirectly by a U.S. party.

The second of the two requirements of the SPV condition in the 2008 temporary regulations is that there is a foreign payment attributable to income of the entity. See §1.901-2T(e)(5)(iv)(B)(1)(ii). The foreign payment may be paid by the entity itself or by the owner(s) of the entity. The 2007 proposed regulations and the 2008 temporary regulations both provide an exception that a foreign payment does not include a withholding tax imposed on distributions or payments made by an entity to a U.S. party. However, the IRS and the Treasury Department have become aware that taxpayers can enter into arrangements that generate duplicative benefits involving foreign withholding taxes imposed on distributions made by an entity to a U.S. party. For example, if the parties undertake a transaction in which interests in an SPV are transferred by the U.S. party to a counterparty subject to a repurchase obligation, withholding taxes imposed on distributions from the SPV may be claimed as creditable in both jurisdictions.

Accordingly, the exception for withholding taxes imposed on distributions or payments to U.S. parties is eliminated from §1.901-2(e)(5)(iv)(B)(1)(ii) of the final regulations. The IRS and the Treasury Department will promulgate additional guidance to clarify that a foreign payment attributable to income of an entity includes a withholding tax imposed on a dividend or other distribution (including distributions made by a pass-through entity or an entity that is disregarded as an entity separate from its owner for U.S. tax purposes) with respect to the equity of the entity.

The 2008 temporary regulations attribute to income of an entity foreign payments attributable to the entity's share of income of a lower-tier entity that is a branch or pass-through entity under either foreign or U.S. law. One comment recommended that the foreign payment rule be modified by eliminating the attribution of foreign payments made by a lower-tier entity that is a branch or pass-through entity under only U.S. law to the income of its owner because such attribution would not occur if the lower-tier entity were regarded as a corporation for U.S. tax purposes. The IRS and the Treasury Department agree with the comment that foreign payments by a lower-tier entity should not be attributed to the income of its owner. In cases where a lower-tier entity is liable for foreign payments under foreign law, the disallowance of foreign tax credits with respect to such taxes should turn on whether that entity, and not the owner of such entity, satisfies the SPV condition. Accordingly, the applicable sentence has been eliminated from §1.901-2(e)(5)(iv)(B)(1)(ii) of the final regulations.

D. Section 1.901-2(e)(5)(iv)(B)(2): U.S. Party

Section 1.901-2(e)(5)(iv)(B)(2) of the final regulations adopts without change the second condition of the 2008 temporary regulations that a U.S. party is a person who is

eligible to claim a credit under section 901(a), including a credit for taxes deemed paid under section 902 or 960, for all or a portion of the foreign payment if the foreign payment were an amount of tax paid (the "U.S. party condition"). Comments recommended that the U.S. party condition be supplemented with a de minimis exception, including an exclusion for U.S. citizens and residents. The IRS and the Treasury Department do not believe that such a modification is consistent with the purposes of these regulations. Therefore, the IRS and the Treasury Department have not adopted this comment.

Another comment recommended that if a U.S. party is a member of an affiliated group of corporations that files a consolidated federal income tax return, then all members of the affiliated group should be treated as a single U.S. party for purposes of applying the final regulations. The IRS and the Treasury Department did not adopt this comment because the final regulations provide aggregation rules that address the comment.

E. Section 1.901-2(e)(5)(iv)(B)(3): Direct Investment

Section 1.901-2(e)(5)(iv)(B)(3) of the final regulations adopts without change the third condition of the 2008 temporary regulations (the "direct investment condition"). The direct investment condition requires that the U.S. party's share of the foreign payment or payments is (or is expected to be) substantially greater than the amount of credits, if any, that the U.S. party reasonably would expect to be eligible to claim under section 901(a) for foreign taxes attributable to income generated by the U.S. party's proportionate share of the assets owned by the SPV if the U.S. party directly owned such assets.

Comments suggested that this condition in the 2008 temporary regulations will always be satisfied because it assumes the assets would not be held through a branch operation subject to net basis taxation and excludes assets that produce income subject to gross basis withholding tax. One comment recommended that the final regulations limit the condition to cases in which the arrangement increases the foreign payments attributable to the U.S. party relative to what would have been paid in the absence of a duplicative tax benefit. In contrast, the 2008 temporary regulations compare the amount of the U.S. party's foreign payment with the amount of taxes that would be expected to be paid if the U.S. party directly owned the assets in question.

The IRS and the Treasury Department disagree with this recommendation. The introduction of a standard that compares the foreign payments arising from a structured passive investment arrangement to alternative transactions that might have been undertaken under different incentives would add administrative complexity and uncertainty in the application of these regulations. Accordingly, the IRS and the Treasury Department have retained the condition unchanged from the 2008 temporary regulations both because it describes one of the abusive aspects of these arrangements and because it ensures that the regulations cannot be avoided through the use of foreign securities that produce income subject to withholding taxes.

F. Section 1.901-2(e)(5)(iv)(B)(4): Foreign Tax Benefit

Section 1.901-2(e)(5)(iv)(B)(4) of the final regulations adopts with minor changes the fourth condition of the 2008 temporary regulations (the "foreign tax benefit condition"). The foreign tax benefit condition requires that the arrangement is reasonably expected to result in a tax benefit to a counterparty (or a related person)

under the laws of a foreign country. If the foreign tax benefit available to the counterparty is a credit, then such credit must correspond to 10 percent or more of the U.S. party's share (for U.S. tax purposes) of the foreign payment. Other types of foreign tax benefits, such as exemptions, deductions, exclusions or losses, must correspond to 10 percent or more of the foreign base with respect to which the U.S. party's share (for U.S. tax purposes) of the foreign payment is imposed.

The IRS and the Treasury Department received several comments with respect to the foreign tax benefit condition. The comments asserted that the rule in the 2008 temporary regulations requiring at least 10 percent correspondence between the foreign tax benefit and the U.S. party's share of the foreign payment ("the 10 percent correspondence requirement") is vague and more difficult to apply than a similar rule in the 2007 proposed regulations. Under the 2007 proposed regulations, any foreign tax benefit satisfied the condition, but the counterparty condition, described below, included minimum ownership requirements. One comment favored the clarity of the 2007 proposed rule. In addition, the comments questioned whether certain types of foreign tax benefits, such as exemptions or reduced tax rates on certain types of income, should be treated as foreign tax benefits for these purposes. Finally, comments sought clarification regarding how the percentage of correspondence is determined in cases involving more than two persons owning an interest in an SPV.

The 10 percent correspondence requirement is intended to limit any potential disallowance of foreign tax credits to cases in which there is a material duplication of the tax benefits. Accordingly, the final regulations retain this requirement. In addition, the final regulations do not exclude any particular tax benefit from the foreign tax benefit

condition because duplication of tax benefits can assume a wide variety of forms. The IRS and the Treasury Department also believe that whether foreign tax benefits duplicate or correspond to the U.S. party's share of the foreign tax benefits will generally be clear and no further elaboration of the rules is required.

Another comment noted that the foreign tax benefit condition may be difficult to apply in cases where the foreign tax benefit is claimed by a party related to the counterparty. The IRS and the Treasury Department concluded that it was necessary to include related parties because of the variety of duplication techniques otherwise available to taxpayers, including the use of benefits arising to members of a related group of entities, and accordingly the comment was not adopted.

Comments sought clarification that in arrangements involving two or more unrelated counterparties, the 10 percent correspondence requirement cannot be satisfied by aggregating the value of duplicative tax benefits received by the unrelated counterparties. The comments assert that the inclusion of benefits received by parties related to a counterparty in the foreign tax benefit condition in the 2008 temporary regulations suggested, by negative implication, that any benefits claimed by unrelated counterparties should not be aggregated. The IRS and the Treasury Department did not adopt this comment. The 10 percent correspondence requirement is intended to ensure that the disallowance of credits applies only where the duplication of tax benefits in the arrangement is material relative to the value of the otherwise creditable foreign payment, irrespective of whether the arrangement involves multiple U.S. parties, multiple counterparties, or both. Thus, in the final regulations the 10 percent correspondence requirement compares the aggregate amount of foreign tax benefits

available to all counterparties and persons related to such counterparties to the aggregate amount of the U.S. parties' share of the foreign payment or the foreign base, as the case may be.

Comments also objected to the language in the foreign tax benefit condition providing that the arrangement is "reasonably expected" to result in a foreign tax benefit. According to the comments, a U.S. party may be unable to assess whether a counterparty is reasonably expected to receive a foreign tax benefit and it would be inappropriate to disallow a foreign tax credit where a U.S. party cannot make such an assessment. The IRS and the Treasury Department believe the reasonableness standard in the 2008 temporary regulations affords sufficient protection against unknowable or unexpected outcomes in the majority of cases. Further, the IRS and the Treasury Department are concerned that an actual knowledge requirement would be difficult to administer. Accordingly, the IRS and the Treasury Department have not adopted this comment.

G. Section 1.901-2(e)(5)(iv)(B)(5): Counterparty

The fifth condition provided in §1.901-2T(e)(5)(iv)(B)(5) of the 2008 temporary regulations is that the arrangement include a person that, under the tax laws of a foreign country in which the person is subject to tax on the basis of place of management, place of incorporation or similar criterion or otherwise subject to a net basis tax, directly or indirectly owns or acquires equity interests in, or assets of, the SPV (the "counterparty condition"). The 2008 temporary regulations provide that a counterparty does not include the SPV or a person with respect to which the same domestic corporation, U.S. citizen or resident alien individual directly or indirectly owns more than 80 percent of the

total value of the stock (or equity interests) of each of the U.S. party and such person. Also, a counterparty does not include a person with respect to which the U.S. party directly or indirectly owns more than 80 percent of the total value of the stock (or equity interests), but only if the U.S. party is a domestic corporation, a U.S. citizen or a resident alien individual.

The IRS and the Treasury Department received several comments with respect to the counterparty condition. Comments noted that in certain tiered structures the rule could treat as a counterparty an upper-tier entity in which a U.S. investor and a foreign investor each hold interests, and that to the extent that the foreign tax benefits resulting from such structures are not duplicative, the counterparty condition is overly broad. For example, if a U.S. investor and foreign investor each own 50 percent of an upper-tier entity which in turn owns an SPV, the comments argue that the exempt treatment of distributions from the SPV to its upper-tier owner is not problematic so long as each of the investors in the upper-tier entity ultimately receives only those tax benefits associated with its 50 percent interest in the upper-tier entity. Comments suggested revising the counterparty condition to exclude such intermediary entities.

The IRS and the Treasury Department agree that foreign tax benefits claimed by a jointly-held upper-tier entity are not problematic so long as none of the indirect U.S. or foreign owners of the SPV claims duplicative tax benefits attributable to the arrangement. However, the IRS and the Treasury Department are concerned that revising the counterparty condition to exclude jointly-held entities could create opportunities for avoidance of the regulations. Accordingly, in lieu of revising the counterparty condition, the final regulations revise the foreign tax benefit condition to

provide that certain tax benefits claimed by upper-tier entities do not correspond to the U.S. party's share of the foreign payment. Specifically, where a U.S. party indirectly owns a non-hybrid equity interest in an SPV, a foreign tax benefit available to a foreign entity in the chain of ownership which begins with the SPV and ends with the first-tier entity in such chain does not correspond to the U.S. party's share of the foreign payment attributable to the SPV to the extent that such benefit relates to earnings of the SPV that are distributed with respect to non-hybrid equity interests in the SPV that are owned indirectly by the U.S. party for purposes of both U.S. and foreign tax law. See §1.901-2(e)(5)(iv)(B)(4). This revision is intended to ensure that the foreign tax benefit condition is not satisfied in cases where the U.S. and foreign investors claim only those tax benefits that are consistent with their respective investments in the arrangement and their interests are treated as equity and owned by the same persons in both jurisdictions.

One comment also recommended that dual citizens or U.S. residents, who are generally subject to U.S. tax on their worldwide income, should not be treated as counterparties because any reduction in foreign tax liability will result in a corresponding increase in U.S. tax. The IRS and the Treasury Department agree with this comment and have modified the final regulations to reflect this change.

One comment also recommended that individuals who are family members of a U.S. party not be treated as counterparties. The IRS and the Treasury Department disagree with the comment. The exception from the counterparty condition for certain U.S.-controlled foreign counterparties is based on the premise that the foreign tax benefit available to such a counterparty confers only a timing benefit that will reverse

when the counterparty repatriates its earnings to the United States. Because such timing benefits are not the focus of these regulations, the 2007 proposed regulations and 2008 temporary regulations excluded certain foreign persons owned by the U.S. party or by certain United States persons who also own the U.S. party. In contrast, where an individual is related to a U.S. party but is not a United States person for U.S. tax purposes, the reduction in foreign tax liability obtained by such individual does not result in a corresponding increase in U.S. tax. Accordingly, the final regulations do not include an exclusion for such individuals.

One comment recommended that individuals receiving stock in connection with the performance of services should not be treated as counterparties. The tax policy concerns of the IRS and the Treasury Department regarding structured transactions addressed by these regulations exist regardless of the means by which a person acquires its interest in an SPV. The presence of a duplicative tax benefit is no less problematic because its recipient acquired its interest in an SPV in return for services instead of capital. Accordingly, this recommendation was not adopted.

One comment recommended that in cases where one U.S. party owns more than 80 percent of a counterparty but another U.S. party does not, the regulations should treat a foreign payment as noncompulsory only to the extent of the unrelated U.S. party's share of the foreign payment. This comment was not adopted. These regulations are intended to disallow foreign tax credits claimed in connection with structured passive investment arrangements. The tax policy concerns of the IRS and the Treasury Department regarding such abusive transactions remain the same

regardless of whether the arrangement satisfies the six conditions of the regulations with respect to one U.S. party or multiple U.S. parties.

One comment recommended that the final regulations adopt the de minimis rule set forth in the 2007 proposed regulations that requires a counterparty to own a certain percentage of the equity or assets of the SPV. In contrast, as explained in the preamble to the 2008 temporary regulations, the 2008 temporary regulations focus on whether there is a duplicative foreign tax benefit. The IRS and the Treasury Department continue to believe that focusing on a threshold amount of duplicative tax benefits is more consistent with the concerns underlying the regulations. Accordingly, this comment is not adopted.

Another comment recommended that the percentage of U.S. ownership required to exclude a person from being treated as a counterparty be reduced from the 2008 temporary regulations' threshold of more than 80 percent. The comment recommended that the threshold be reduced to either 80 percent or more, or 75 percent or more. The IRS and the Treasury Department do not believe that the proposal is consistent with the policy concerns addressed by these final regulations. Accordingly, this comment is not adopted.

H. Section 1.901-2(e)(5)(iv)(B)(6): Inconsistent Treatment

The IRS and the Treasury Department also received several comments with respect to the sixth condition of the 2008 temporary regulations (the "inconsistent treatment condition"). The inconsistent treatment condition requires that the United States and an applicable foreign country treat the arrangement inconsistently under their respective tax systems and that the U.S. treatment results in either materially less

income or a materially greater amount of foreign tax credits than would be available if the foreign law controlled the U.S. tax treatment. This condition is intended to limit the disallowance of credits to those arrangements that exploit inconsistencies in U.S. and foreign law to secure a foreign tax credit benefit.

A comment recommended that the final regulations adopt an additional requirement that the foreign tax benefit obtained by the counterparty be materially less if the U.S. tax treatment controlled for foreign tax purposes as well. The recommendation is intended to require that both the U.S. party's share of the foreign payments and the foreign tax benefit arise from the inconsistent treatment. The IRS and the Treasury Department believe that the foreign tax benefit condition of the 2008 temporary regulations is sufficient to ensure that the foreign tax benefit corresponds to or duplicates the U.S. party's share of the foreign payments or the foreign base and that such duplication is sufficiently indicative of inconsistency. Therefore, the IRS and the Treasury Department believe that any additional requirement under the inconsistent treatment condition is unnecessary, and the comment was not adopted.

These final regulations clarify the application of the inconsistent treatment condition in cases where multiple U.S. parties exist. Where an arrangement involves multiple U.S. parties, the inconsistent treatment condition is satisfied only if the amount of income attributable to the SPV that is recognized for U.S. tax purposes by the SPV and all the U.S. parties (and persons related to the U.S. party or parties) is materially less than the amount of income that would be recognized if the foreign tax treatment controlled for U.S. tax purposes or if the amount of foreign tax credits claimed by all

U.S. parties is materially greater than it would be if the foreign tax treatment controlled for U.S. tax purposes.

I. Examples

These final regulations provide two new examples to illustrate changes that were adopted in the final regulations. Example 8 illustrates the application of the holding company exception when there is more than one U.S. party or more than one counterparty. Example 12 illustrates the application of the revised foreign tax benefit condition to a tiered holding company structure. Modifications to examples in the 2008 temporary regulations were also made to reflect comments received and other changes to the regulations.

J. Miscellaneous Amendments

These final regulations adopt with minor changes amendments made by the 2008 temporary regulations to §1.901-1(a) and (b) to reflect statutory changes made by the Foreign Investors Tax Act of 1966 (Public Law 89-809 (80 Stat. 1539), section 106(b)), the Tax Reform Act of 1976 (Public Law 94-455 (90 Stat. 1520), section 1901(a)(114)), and the American Jobs Creation Act of 2004 (Public Law 108-357 (118 Stat. 1418-20), section 405(b)).

K. Effective Date

These final regulations generally apply to payments that, if such payments were an amount of tax paid, would be considered paid or accrued on or after [**INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER**].

The IRS and the Treasury Department will continue to closely scrutinize other

arrangements that are not covered by the regulations but produce inappropriate foreign tax credit results. Such arrangements may include arrangements that are similar to arrangements described in the final regulations, but that do not meet all of the conditions included in the final regulations. The IRS will continue to challenge the claimed U.S. tax results in appropriate cases, including under judicial doctrines. The IRS and the Treasury Department may also issue additional regulations in the future to address such other arrangements.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have foreign operations which tend to be larger businesses. Moreover the number of taxpayers affected and the average burden are minimal. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Jeffrey P. Cowan, Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.901-1 is amended by revising paragraphs (a) and (b), and adding a second sentence in paragraph (j) to read as follows:

§1.901-1 Allowance of credit for taxes.

(a) In general. Citizens of the United States, domestic corporations, and certain aliens resident in the United States or Puerto Rico may choose to claim a credit, as provided in section 901, against the tax imposed by chapter 1 of the Internal Revenue Code (Code) for taxes paid or accrued to foreign countries and possessions of the United States, subject to the conditions prescribed in paragraphs (a)(1) through (a)(3) and paragraph (b) of this section.

(1) Citizen of the United States. A citizen of the United States, whether resident or nonresident, may claim a credit for--

(i) The amount of any income, war profits, and excess profits taxes paid or

accrued during the taxable year to any foreign country or to any possession of the United States; and

(ii) His share of any such taxes of a partnership of which he is a member, or of an estate or trust of which he is a beneficiary.

(2) Domestic corporation. A domestic corporation may claim a credit for--

(i) The amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States;

(ii) Its share of any such taxes of a partnership of which it is a member, or of an estate or trust of which it is a beneficiary; and

(iii) The taxes deemed to have been paid under section 902 or 960.

(3) Alien resident of the United States or Puerto Rico. Except as provided in a Presidential proclamation described in section 901(c), an alien resident of the United States, or an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, may claim a credit for--

(i) The amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

(ii) His distributive share of any such taxes of a partnership of which he is a member, or of an estate or trust of which he is a beneficiary.

(b) Limitations. Certain Code sections, including sections 814, 901(e) through (m), 904, 906, 907, 908, 909, 911, 999, and 6038, limit the credit against the tax imposed by chapter 1 of the Code for certain foreign taxes.

* * * * *

(j) Effective/applicability date. * * * Paragraphs (a) and (b) of this section apply to taxable years ending after [**INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER**].

§1.901-1T [Removed].

Par. 3. Section 1.901-1T is removed.

Par. 4. Section 1.901-2 is amended by removing and reserving paragraph (e)(5)(iii), revising paragraph (e)(5)(iv), and revising paragraph (h)(2) to read as follows:

§1.901-2 Income, war profits, or excess profits tax paid or accrued.

* * * * *

(e) * * *

(5) * * *

(iii) [Reserved].

(iv) Structured passive investment arrangements--(A) In general. Notwithstanding paragraph (e)(5)(i) of this section, an amount paid to a foreign country (a "foreign payment") is not a compulsory payment, and thus is not an amount of tax paid, if the foreign payment is attributable (within the meaning of paragraph (e)(5)(iv)(B)(1)(ii) of this section) to a structured passive investment arrangement (as described in paragraph (e)(5)(iv)(B) of this section).

(B) Conditions. An arrangement is a structured passive investment arrangement if all of the following conditions are satisfied:

(1) Special purpose vehicle (SPV). An entity that is part of the arrangement

meets the following requirements:

(i) Substantially all of the gross income (for U.S. tax purposes) of the entity, if any, is passive investment income, and substantially all of the assets of the entity are assets held to produce such passive investment income.

(ii) There is a foreign payment attributable to income of the entity (as determined under the laws of the foreign country to which such foreign payment is made), including the entity's share of income of a lower-tier entity that is a branch or pass-through entity under the laws of such foreign country, that, if the foreign payment were an amount of tax paid, would be paid or accrued in a U.S. taxable year in which the entity meets the requirements of paragraph (e)(5)(iv)(B)(1)(i) of this section. A foreign payment attributable to income of an entity includes a foreign payment attributable to income that is required to be taken into account by an owner of the entity, if the entity is a branch or pass-through entity under the laws of such foreign country.

(2) U.S. party. A person would be eligible to claim a credit under section 901(a) (including a credit for foreign taxes deemed paid under section 902 or 960) for all or a portion of the foreign payment described in paragraph (e)(5)(iv)(B)(1)(ii) of this section if the foreign payment were an amount of tax paid.

(3) Direct investment. The U.S. party's proportionate share of the foreign payment or payments described in paragraph (e)(5)(iv)(B)(1)(ii) of this section is (or is expected to be) substantially greater than the amount of credits, if any, that the U.S. party reasonably would expect to be eligible to claim under section 901(a) for foreign taxes attributable to income generated by the U.S. party's proportionate share of the assets owned by the SPV if the U.S. party directly owned such assets. For this

purpose, direct ownership shall not include ownership through a branch, a permanent establishment or any other arrangement (such as an agency arrangement or dual resident status) that would result in the income generated by the U.S. party's proportionate share of the assets being subject to tax on a net basis in the foreign country to which the payment is made. A U.S. party's proportionate share of the assets of the SPV shall be determined by reference to such U.S. party's proportionate share of the total value of all of the outstanding interests in the SPV that are held by its equity owners and creditors. A U.S. party's proportionate share of the assets of the SPV, however, shall not include any assets that produce income subject to gross basis withholding tax.

(4) Foreign tax benefit. The arrangement is reasonably expected to result in a credit, deduction, loss, exemption, exclusion or other tax benefit under the laws of a foreign country that is available to a counterparty or to a person that is related to the counterparty (determined under the principles of paragraph (e)(5)(iv)(C)(7) of this section by applying the tax laws of a foreign country in which the counterparty is subject to tax on a net basis). However, a foreign tax benefit in the form of a credit is described in this paragraph (e)(5)(iv)(B)(4) only if the amount of any such credit corresponds to 10 percent or more of the amount of the U.S. party's share (for U.S. tax purposes) of the foreign payment referred to in paragraph (e)(5)(iv)(B)(1)(ii) of this section. In addition, a foreign tax benefit in the form of a deduction, loss, exemption, exclusion or other tax benefit is described in this paragraph (e)(5)(iv)(B)(4) only if such amount corresponds to 10 percent or more of the foreign base with respect to which the U.S. party's share (for U.S. tax purposes) of the foreign payment is imposed. For purposes of the preceding

two sentences, if an arrangement involves more than one U.S. party or more than one counterparty or both, the aggregate amount of foreign tax benefits available to all of the counterparties and persons related to such counterparties is compared to the aggregate amount of all of the U.S. parties' shares of the foreign payment or foreign base, as the case may be. Where a U.S. party indirectly owns interests in an SPV that are treated as equity interests for both U.S. and foreign tax purposes, a foreign tax benefit available to a foreign entity in the chain of ownership that begins with the SPV and ends with the first-tier entity in the chain does not correspond to the U.S. party's share of the foreign payment attributable to income of the SPV to the extent that such benefit relates to earnings of the SPV that are distributed with respect to equity interests in the SPV that are owned directly or indirectly by the U.S. party for purposes of both U.S. and foreign tax law.

(5) Counterparty. The arrangement involves a counterparty. A counterparty is a person that, under the tax laws of a foreign country in which the person is subject to tax on the basis of place of management, place of incorporation or similar criterion or otherwise subject to a net basis tax, directly or indirectly owns or acquires equity interests in, or assets of, the SPV. However, a counterparty does not include the SPV or a person with respect to which for U.S. tax purposes the same domestic corporation, U.S. citizen or resident alien individual directly or indirectly owns more than 80 percent of the total value of the stock (or equity interests) of each of the U.S. party and such person. A counterparty also does not include a person with respect to which for U.S. tax purposes the U.S. party directly or indirectly owns more than 80 percent of the total value of the stock (or equity interests), but only if the U.S. party is a domestic

corporation, a U.S. citizen or a resident alien individual. In addition, a counterparty does not include an individual who is a U.S. citizen or resident alien.

(6) Inconsistent treatment. The United States and an applicable foreign country treat one or more of the aspects of the arrangement listed in paragraph (e)(5)(iv)(B)(6)(i) through (e)(5)(iv)(B)(6)(iv) of this section differently under their respective tax systems, and for one or more tax years when the arrangement is in effect one or both of the following two conditions applies; either the amount of income attributable to the SPV that is recognized for U.S. tax purposes by the SPV, the U.S. party or parties, and persons related to a U.S. party or parties is materially less than the amount of income that would be recognized if the foreign tax treatment controlled for U.S. tax purposes; or the amount of credits claimed by the U.S. party or parties (if the foreign payment described in paragraph (e)(5)(iv)(B)(1)(ii) of this section were an amount of tax paid) is materially greater than it would be if the foreign tax treatment controlled for U.S. tax purposes:

(i) The classification of the SPV (or an entity that has a direct or indirect ownership interest in the SPV) as a corporation or other entity subject to an entity-level tax, a partnership or other flow-through entity or an entity that is disregarded for tax purposes.

(ii) The characterization as debt, equity or an instrument that is disregarded for tax purposes of an instrument issued by the SPV (or an entity that has a direct or indirect ownership interest in the SPV) to a U.S. party, a counterparty or a person related to a U.S. party or a counterparty.

(iii) The proportion of the equity of the SPV (or an entity that directly or indirectly

owns the SPV) that is considered to be owned directly or indirectly by a U.S. party and a counterparty.

(iv) The amount of taxable income that is attributable to the SPV for one or more tax years during which the arrangement is in effect.

(C) Definitions. The following definitions apply for purposes of paragraph (e)(5)(iv) of this section.

(1) Applicable foreign country. An applicable foreign country means each foreign country to which a foreign payment described in paragraph (e)(5)(iv)(B)(1)(ii) of this section is made or which confers a foreign tax benefit described in paragraph (e)(5)(iv)(B)(4) of this section.

(2) Counterparty. The term counterparty means a person described in paragraph (e)(5)(iv)(B)(5) of this section.

(3) Entity. The term entity includes a corporation, trust, partnership or disregarded entity described in §301.7701-2(c)(2)(i).

(4) Indirect ownership. Indirect ownership of stock or another equity interest (such as an interest in a partnership) shall be determined in accordance with the principles of section 958(a)(2), regardless of whether the interest is owned by a U.S. or foreign entity.

(5) Passive investment income--(i) In general. The term passive investment income means income described in section 954(c), as modified by this paragraph (e)(5)(iv)(C)(5)(i) and paragraph (e)(5)(iv)(C)(5)(ii) of this section. In determining whether income is described in section 954(c), paragraphs (c)(1)(H), (c)(3), and (c)(6) of that section shall be disregarded. Sections 954(c), 954(h), and 954(i) shall be applied

at the entity level as if the entity (as defined in paragraph (e)(5)(iv)(C)(3) of this section) were a controlled foreign corporation (as defined in section 957(a)). For purposes of determining if sections 954(h) and 954(i) apply for purposes of this paragraph (e)(5)(iv)(C)(5)(i) and paragraph (e)(5)(iv)(C)(5)(ii) of this section, any income of an entity attributable to transactions that, assuming the entity is an SPV, are with a person that is a counterparty, or with persons that are related to a counterparty within the meaning of paragraph (e)(5)(iv)(B)(4) of this section, shall not be treated as qualified banking or financing income or as qualified insurance income, and shall not be taken into account in applying sections 954(h) and 954(i) for purposes of determining whether other income of the entity is excluded from section 954(c)(1) under section 954(h) or 954(i), but only if any such person (or a person that is related to such person within the meaning of paragraph (e)(5)(iv)(B)(4) of this section) is eligible for a foreign tax benefit described in paragraph (e)(5)(iv)(B)(4) of this section. In addition, in applying section 954(h) for purposes of this paragraph (e)(5)(iv)(C)(5)(i) and paragraph (e)(5)(iv)(C)(5)(ii) of this section, section 954(h)(3)(E) shall not apply, section 954(h)(2)(A)(ii) shall be satisfied only if the entity conducts substantial activity with respect to its business through its own employees, and the term “any foreign country” shall be substituted for “home country” wherever it appears in section 954(h).

(ii) Income attributable to lower-tier entities; holding company exception. Income of an upper-tier entity that is attributable to an equity interest in a lower-tier entity, including dividends, an allocable share of partnership income, and income attributable to the ownership of an interest in an entity that is disregarded as an entity separate from its owner is passive investment income unless substantially all of the upper-tier entity’s

assets consist of qualified equity interests in one or more lower-tier entities, each of which is engaged in the active conduct of a trade or business and derives more than 50 percent of its gross income from such trade or business, and substantially all of the upper-tier entity's opportunity for gain and risk of loss with respect to each such interest in a lower-tier entity is shared by the U.S. party (or persons that are related to a U.S. party) and, assuming the entity is an SPV, a counterparty (or persons that are related to a counterparty) ("holding company exception"). If an arrangement involves more than one U.S. party or more than one counterparty or both, then substantially all of the upper-tier entity's opportunity for gain and risk of loss with respect to its interest in any lower-tier entity must be shared (directly or indirectly) by one or more U.S. parties (or persons related to such U.S. parties) and, assuming the upper-tier entity is an SPV, one or more counterparties (or persons related to such counterparties). Substantially all of the upper-tier entity's opportunity for gain and risk of loss with respect to its interest in any lower-tier entity is not shared if the opportunity for gain and risk of loss is borne (directly or indirectly) by one or more U.S. parties (or persons related to such U.S. party or parties) or, assuming the upper-tier entity is an SPV, by one or more counterparties (or persons related to such counterparty or counterparties). Whether and the extent to which a person is considered to share in an upper-tier entity's opportunity for gain and risk of loss is determined based on all the facts and circumstances, provided, however, that a person does not share in an upper-tier entity's opportunity for gain and risk of loss if its equity interest in the upper-tier entity was acquired in a sale-repurchase transaction or if its interest is treated as debt for U.S. tax purposes. If a U.S. party owns an interest in an entity indirectly through a chain of entities, the application of the holding company

exception begins with the lowest-tier entity in the chain that may satisfy the holding company exception and proceeds upward; provided, however, that the opportunity for gain and risk of loss borne by any upper-tier entity in the chain that is a counterparty shall be disregarded to the extent borne indirectly by a U.S. party. An upper-tier entity that satisfies the holding company exception is itself considered to be engaged in the active conduct of a trade or business and to derive more than 50 percent of its gross income from such trade or business for purposes of applying the holding company exception to the owners of such entity. A lower-tier entity that is engaged in a banking, financing, or similar business shall not be considered to be engaged in the active conduct of a trade or business unless the income derived by such entity would be excluded from section 954(c)(1) under section 954(h) or 954(i) as modified by paragraph (e)(5)(iv)(C)(5)(i) of this section.

(6) Qualified equity interest. With respect to an interest in a corporation, the term qualified equity interest means stock representing 10 percent or more of the total combined voting power of all classes of stock entitled to vote and 10 percent or more of the total value of the stock of the corporation or disregarded entity, but does not include any preferred stock (as defined in section 351(g)(3)). Similar rules shall apply to determine whether an interest in an entity other than a corporation is a qualified equity interest.

(7) Related person. Two persons are related if--

(i) One person directly or indirectly owns stock (or an equity interest) possessing more than 50 percent of the total value of the other person; or

(ii) The same person directly or indirectly owns stock (or an equity interest)

possessing more than 50 percent of the total value of both persons.

(8) Special purpose vehicle (SPV). The term SPV means the entity described in paragraph (e)(5)(iv)(B)(1) of this section.

(9) U.S. party. The term U.S. party means a person described in paragraph (e)(5)(iv)(B)(2) of this section.

(D) Examples. The following examples illustrate the rules of paragraph (e)(5)(iv) of this section. No inference is intended as to whether a taxpayer would be eligible to claim a credit under section 901(a) if a foreign payment were an amount of tax paid. The examples set forth below do not limit the application of other principles of existing law to determine the proper tax consequences of the structures or transactions addressed in the regulations.

Example 1. U.S. borrower transaction. (i) Facts. A domestic corporation (USP) forms a country M corporation (Newco), contributing $1.5 billion in exchange for 100% of the stock of Newco. Newco, in turn, loans the $1.5 billion to a second country M corporation (FSub) wholly owned by USP. USP then sells its entire interest in Newco to a country M corporation (FP) for the original purchase price of $1.5 billion, subject to an obligation to repurchase the interest in five years for $1.5 billion. The sale has the effect of transferring ownership of the Newco stock to FP for country M tax purposes. Assume the sale-repurchase transaction is structured in a way that qualifies as a collateralized loan for U.S. tax purposes. Therefore, USP remains the owner of the Newco stock for U.S. tax purposes. In year 1, FSub pays Newco $120 million of interest. Newco pays $36 million to country M with respect to such interest income and distributes the remaining $84 million to FP. Under country M law, the $84 million distribution is excluded from FP's income. None of FP's stock is owned, directly or indirectly, by USP or any shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Under an income tax treaty between country M and the United States, country M does not impose country M tax on interest received by U.S. residents from sources in country M.

(ii) Result. The $36 million payment by Newco to country M is not a compulsory payment, and thus is not an amount of tax paid because the foreign payment is attributable to a structured passive investment arrangement. First, Newco is an SPV because all of Newco's income is passive investment income described in paragraph (e)(5)(iv)(C)(5) of this section; Newco's only asset, a note, is held to produce such income; the payment to country M is attributable to such income; and if the payment

were an amount of tax paid it would be paid or accrued in a U.S. taxable year in which Newco meets the requirements of paragraph (e)(5)(iv)(B)(1)(i) of this section. Second, if the foreign payment were treated as an amount of tax paid, USP would be deemed to pay the foreign payment under section 902(a) and, therefore, would be eligible to claim a credit for such payment under section 901(a). Third, USP would not pay any country M tax if it directly owned Newco's loan receivable. Fourth, the distribution from Newco to FP is exempt from tax under country M law, and the exempt amount corresponds to more than 10% of the foreign base with respect to which USP's share (which is 100% under U.S. tax law) of the foreign payment was imposed. Fifth, FP is a counterparty because FP owns stock of Newco under country M law and none of FP's stock is owned by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, FP is the owner of 100% of Newco's stock for country M tax purposes, while USP is the owner of 100% of Newco's stock for U.S. tax purposes, and the amount of credits claimed by USP if the payment to country M were an amount of tax paid is materially greater than it would be if country M tax treatment controlled for U.S. tax purposes such that FP, rather than USP, owned 100% of Newco's stock. Because the payment to country M is not an amount of tax paid, USP is not deemed to pay any country M tax under section 902(a). USP has dividend income of $84 million and also has interest expense of $84 million. FSub's post-1986 undistributed earnings are reduced by $120 million of interest expense.

Example 2. U.S. borrower transaction. (i) Facts. The facts are the same as in Example 1, except that FSub is a wholly-owned subsidiary of Newco. In addition, assume FSub is engaged in the active conduct of manufacturing and selling widgets and derives more than 50% of its gross income from such business.

(ii) Result. The results are the same as in Example 1. Although Newco wholly owns FSub, which is engaged in the active conduct of manufacturing and selling widgets and derives more than 50% of its income from such business, Newco's income that is attributable to Newco's equity interest in FSub is passive investment income because the sale-repurchase transaction limits FP's interest in Newco and its assets to that of a creditor, so that substantially all of Newco's opportunity for gain and risk of loss with respect to its stock in FSub is borne by USP. See paragraph (e)(5)(iv)(C)(5)(ii) of this section. Accordingly, Newco's stock in FSub is held to produce passive investment income. Thus, Newco is an SPV because all of Newco's income is passive investment income described in paragraph (e)(5)(iv)(C)(5) of this section, Newco's assets are held to produce such income, the payment to country M is attributable to such income, and if the payment were an amount of tax paid it would be paid or accrued in a U.S. taxable year in which Newco meets the requirements of paragraph (e)(5)(iv)(B)(1)(i) of this section.

Example 3. U.S. borrower transaction. (i) Facts. (A) A domestic corporation (USP) loans $750 million to its wholly-owned domestic subsidiary (Sub). USP and Sub form a country M partnership (Partnership) to which each contributes $750 million. Partnership loans all of its $1.5 billion of capital to Issuer, a wholly-owned country M affiliate of USP, in exchange for a note and coupons providing for the payment of interest at a fixed rate over a five-year term. Partnership sells all of the coupons to

Coupon Purchaser, a country N partnership owned by a country M corporation (Foreign Bank) and a wholly-owned country M subsidiary of Foreign Bank, for $300 million. At the time of the coupon sale, the fair market value of the coupons sold is $290 million and, pursuant to section 1286(b)(3), Partnership's basis allocated to the coupons sold is $290 million. Several months later and prior to any interest payments on the note, Foreign Bank and its subsidiary sell all of their interests in Coupon Purchaser to an unrelated country O corporation for $280 million. None of Foreign Bank's stock or its subsidiary's stock is owned, directly or indirectly, by USP or Sub or by any shareholders of USP or Sub that are domestic corporations, U.S. citizens, or resident alien individuals.

(B) Assume that both the United States and country M respect the sale of the coupons for tax law purposes. In the year of the coupon sale, for country M tax purposes USP's and Sub's shares of Partnership's profits total $300 million, a payment of $60 million to country M is made with respect to those profits, and Foreign Bank and its subsidiary, as partners of Coupon Purchaser, are entitled to deduct the $300 million purchase price of the coupons from their taxable income. For U.S. tax purposes, USP and Sub recognize their distributive shares of the $10 million premium income and claim a direct foreign tax credit for their shares of the $60 million payment to country M. Country M imposes no additional tax when Foreign Bank and its subsidiary sell their interests in Coupon Purchaser. Country M also does not impose country M tax on interest received by U.S. residents from sources in country M.

(ii) Result. The payment to country M is not a compulsory payment, and thus is not an amount of tax paid, because the foreign payment is attributable to a structured passive investment arrangement. First, Partnership is an SPV because all of Partnership's income is passive investment income described in paragraph (e)(5)(iv)(C)(5) of this section; Partnership's only asset, Issuer's note, is held to produce such income; the payment to country M is attributable to such income; and if the payment were an amount of tax paid, it would be paid or accrued in a U.S. taxable year in which Partnership meets the requirements of paragraph (e)(5)(iv)(B)(1)(i) of this section. Second, if the foreign payment were an amount of tax paid, USP and Sub would be eligible to claim a credit for such payment under section 901(a). Third, USP and Sub would not pay any country M tax if they directly owned Issuer's note. Fourth, for country M tax purposes, Foreign Bank and its subsidiary deduct the $300 million purchase price of the coupons and are exempt from country M tax on the $280 million received upon the sale of Coupon Purchaser, and the deduction and exemption correspond to more than 10% of the $300 million base with respect to which USP's and Sub's 100% share of the foreign payments was imposed. Fifth, Foreign Bank and its subsidiary are counterparties because they indirectly acquired assets of Partnership, the interest coupons on Issuer's note, and are not directly or indirectly owned by USP or Sub or shareholders of USP or Sub that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, the amount of taxable income of Partnership for one or more years is different for U.S. and country M tax purposes, and the amount of income attributable to USP and Sub for U.S. tax purposes is materially less than the amount of income they would recognize if the country M tax treatment of the coupon sale controlled for U.S. tax purposes. Because the payment to country M is not an amount of tax paid, USP and Sub are not considered to pay tax under section 901. USP and

Sub have income of $10 million in the year of the coupon sale.

Example 4. Active business; no SPV. (i) Facts. A, a domestic corporation, wholly owns B, a country X corporation engaged in the manufacture and sale of widgets. On January 1, year 1, C, also a country X corporation, loans $400 million to B in exchange for an instrument that is debt for U.S. tax purposes and equity in B for country X tax purposes. As a result, C is considered to own stock of B for country X tax purposes. B loans $55 million to D, a country Y corporation wholly owned by A. In year 1, B has $166 million of net income attributable to its sales of widgets and $3.3 million of interest income attributable to the loan to D. Substantially all of B's assets are used in its widget business. Country Y does not impose tax on interest paid to nonresidents. B makes a payment of $50.8 million to country X with respect to B's net income. Country X does not impose tax on dividend payments between country X corporations. None of C's stock is owned, directly or indirectly, by A or by any shareholders of A that are domestic corporations, U.S. citizens, or resident alien individuals.

(ii) Result. B is not an SPV within the meaning of paragraph (e)(5)(iv)(B)(1) of this section because the amount of interest income received from D does not constitute substantially all of B's income and the $55 million note from D does not constitute substantially all of B's assets. Accordingly, the $50.8 million payment to country X is not attributable to a structured passive investment arrangement.

Example 5 . U.S. lender transaction. (i) Facts. (A) A country X corporation (Foreign Bank) contributes $2 billion to a newly-formed country X company (Newco) in exchange for 90% of the common stock of Newco and securities that are treated as debt of Newco for U.S. tax purposes and preferred stock of Newco for country X tax purposes. A domestic corporation (USP) contributes $1 billion to Newco in exchange for 10% of Newco's common stock and securities that are treated as preferred stock of Newco for U.S. tax purposes and debt of Newco for country X tax purposes. Newco loans the $3 billion to a wholly-owned, country X subsidiary of Foreign Bank (FSub) in return for a $3 billion, seven-year note paying interest currently. The Newco securities held by USP entitle the holder to fixed distributions of $4 million per year, and the Newco securities held by Foreign Bank entitle the holder to receive $82 million per year, payable only on maturity of the $3 billion FSub note in year 7. At the end of year 5, pursuant to a prearranged plan, Foreign Bank acquires USP's Newco stock and securities for a prearranged price of $1 billion. Country X does not impose tax on dividends received by one country X corporation from a second country X corporation. Under an income tax treaty between country X and the United States, country X does not impose country X tax on interest received by U.S. residents from sources in country X. None of Foreign Bank's stock is owned, directly or indirectly, by USP or any shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals.

(B) In each of years 1 through 7, FSub pays Newco $124 million of interest on the $3 billion note. Newco distributes $4 million to USP in each of years 1 through 5. The distributions are deductible for country X tax purposes, and Newco pays country X $36 million with respect to $120 million of taxable income from the FSub note in each

year. For U.S. tax purposes, in each year Newco's post-1986 undistributed earnings are increased by $124 million of interest income and reduced by accrued interest expense with respect to the Newco securities held by Foreign Bank.

(ii) Result. The $36 million payment to country X is not a compulsory payment, and thus is not an amount of tax paid, because the foreign payment is attributable to a structured passive investment arrangement. First, Newco is an SPV because all of Newco's income is passive investment income described in paragraph (e)(5)(iv)(C)(5) of this section; Newco's only asset, a note of FSub, is held to produce such income; the payment to country X is attributable to such income; and if the payment were an amount of tax paid it would be paid or accrued in a U.S. taxable year in which Newco meets the requirements of paragraph (e)(5)(iv)(B)(1)(i) of this section. Second, if the foreign payment were an amount of tax paid, USP would be deemed to pay its pro rata share of the foreign payment under section 902(a) in each of years 1 through 5 and, therefore, would be eligible to claim a credit under section 901(a). Third, USP would not pay any country X tax if it directly owned its proportionate share of Newco's assets, a note of FSub. Fourth, for country X tax purposes, Foreign Bank is eligible to receive a tax-free distribution of $82 million attributable to each of years 1 through 5, and that amount corresponds to more than 10% of the foreign base with respect to which USP's share of the foreign payment was imposed. Fifth, Foreign Bank is a counterparty because it owns stock of Newco for country X tax purposes and none of Foreign Bank's stock is owned, directly or indirectly, by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, the United States and country X treat various aspects of the arrangement differently, including whether the Newco securities held by Foreign Bank and USP are debt or equity. The amount of credits claimed by USP if the payment to country X were an amount of tax paid is materially greater than it would be if the country X tax treatment controlled for U.S. tax purposes such that the securities held by USP were treated as debt or the securities held by Foreign Bank were treated as equity, and the amount of income recognized by Newco for U.S. tax purposes is materially less than the amount of income recognized for country X tax purposes. Because the payment to country X is not an amount of tax paid, USP is not deemed to pay any country X tax under section 902(a). USP has dividend income of $4 million in each of years 1 through 5.

Example 6. Holding company; no SPV. (i) Facts. A, a country X corporation, and B, a domestic corporation, each contribute $1 billion to a newly-formed country X entity (C) in exchange for 50% of the common stock of C. C is treated as a corporation for country X purposes and a partnership for U.S. tax purposes. C contributes $1.95 billion to a newly-formed country X corporation (D) in exchange for 100% of D's common stock. C loans its remaining $50 million to D. Accordingly, C's sole assets are stock and debt of D. D uses the entire $2 billion to engage in the business of manufacturing and selling widgets. In year 1, D derives $300 million of income from its widget business and derives $2 million of interest income. Also in year 1, C has dividend income of $200 million and interest income of $3.2 million with respect to its investment in D. Country X does not impose tax on dividends received by one country X corporation from a second country X corporation. C makes a payment of $960,000 to country X with respect to C's net income.

(ii) Result. C qualifies for the holding company exception described in paragraph (e)(5)(iv)(C)(5)(ii) of this section because C holds a qualified equity interest in D, D is engaged in an active trade or business and derives more than 50% of its gross income from such trade or business, C's interest in D constitutes substantially all of C's assets, and A and B share in substantially all of C's opportunity for gain and risk of loss with respect to D. As a result, C's dividend income from D is not passive investment income and C's stock in D is not held to produce such income. Accordingly, C is not an SPV within the meaning of paragraph (e)(5)(iv)(B)(1) of this section, and the $960,000 payment to country X is not attributable to a structured passive investment arrangement.

Example 7. Holding company; no SPV. (i) Facts. The facts are the same as in Example 6, except that instead of loaning $50 million to D, C contributes the $50 million to E in exchange for 10% of the stock of E. E is a country Y corporation that is not engaged in the active conduct of a trade or business. Also in year 1, D pays no dividends to C, E pays $3.2 million in dividends to C, and C makes a payment of $960,000 to country X with respect to C's net income.

(ii) Result. C qualifies for the holding company exception described in paragraph (e)(5)(iv)(C)(5)(ii) of this section because C holds a qualified equity interest in D, D is engaged in an active trade or business and derives more than 50% of its gross income from such trade or business, C's interest in D constitutes substantially all of C's assets, and A and B share in substantially all of C's opportunity for gain and risk of loss with respect to D. As a result, less than substantially all of C's assets are held to produce passive investment income. Accordingly, C is not an SPV because it does not meet the requirements of paragraph (e)(5)(iv)(B)(1) of this section, and the $960,000 payment to country X is not attributable to a structured passive investment arrangement.

Example 8. Holding company; no SPV. (i) Facts. The facts are the same as in Example 6, except that B's $1 billion investment in C consists of 30% of C's common stock and 100% of C's preferred stock. A's $1 billion investment in C consists of 70% of C's common stock. B sells its preferred stock to F, a country X corporation, subject to a repurchase obligation. Assume that under country X tax law, but not U.S. tax law, F is treated as the owner of the preferred shares and receives a distribution in year 1 of $50 million. The remaining earnings are distributed 70% to A and 30% to B.

(ii) Result. C qualifies for the holding company exception described in paragraph (e)(5)(iv)(C)(5)(ii) of this section because C holds a qualified equity interest in D, D is engaged in an active trade or business and derives more than 50% of its gross income from such trade or business, and C's interest in D constitutes substantially all of C's assets. Additionally, although F does not share in C's opportunity for gain and risk of loss with respect to C's interest in D because F acquired its interest in C in a sale-repurchase transaction, B (the U.S. party) and in the aggregate A and F (who would be counterparties assuming C were an SPV) share in substantially all of C's opportunity for

gain and risk of loss with respect to D and such opportunity for gain and risk of loss is not borne exclusively either by B or by A and F in the aggregate. Accordingly, C's shares in D are not held to produce passive investment income and the $200 million dividend from D is not passive investment income. C is not an SPV within the meaning of paragraph (e)(5)(iv)(B)(1) of this section, and the $960,000 payment to country X is not attributable to a structured passive investment arrangement.

Example 9. Asset holding transaction. (i) Facts. (A) A domestic corporation (USP) contributes $6 billion of country Z debt obligations to a country Z entity (DE) in exchange for all of the class A and class B stock of DE. DE is a disregarded entity for U.S. tax purposes and a corporation for country Z tax purposes. A corporation unrelated to USP and organized in country Z (FC) contributes $1.5 billion to DE in exchange for all of the class C stock of DE. DE uses the $1.5 billion contributed by FC to redeem USP's class B stock. The terms of the class C stock entitle its holder to all income from DE, but FC is obligated immediately to contribute back to DE all distributions on the class C stock. USP and FC enter into--

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

(2) An agreement under which USP agrees to pay FC periodic payments on $1.5 billion.

(B) The transaction is structured in such a way that, for U.S. tax purposes, there is a loan of $1.5 billion from FC to USP, and USP is the owner of the class C stock and the class A stock. In year 1, DE earns $400 million of interest income on the country Z debt obligations. DE makes a payment to country Z of $100 million with respect to such income and distributes the remaining $300 million to FC. FC contributes the $300 million back to DE. None of FC's stock is owned, directly or indirectly, by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Assume that country Z imposes a withholding tax on interest income derived by U.S. residents.

(C) Country Z treats FC as the owner of the class C stock. Pursuant to country Z tax law, FC is required to report the $400 million of income with respect to the $300 million distribution from DE, but is allowed to claim credits for DE's $100 million payment to country Z. For country Z tax purposes, FC is entitled to current deductions equal to the $300 million contributed back to DE.

(ii) Result. The payment to country Z is not a compulsory payment, and thus is not an amount of tax paid because the payment is attributable to a structured passive investment arrangement. First, DE is an SPV because all of DE's income is passive investment income described in paragraph (e)(5)(iv)(C)(5) of this section; all of DE's assets are held to produce such income; the payment to country Z is attributable to such income; and if the payment were an amount of tax paid it would be paid or accrued in a U.S. taxable year in which DE meets the requirements of paragraph

(e)(5)(iv)(B)(1)(i) of this section. Second, if the payment were an amount of tax paid, USP would be eligible to claim a credit for such amount under section 901(a). Third, USP's proportionate share of DE's foreign payment of $100 million is substantially greater than the amount of credits USP would be eligible to claim if it directly held its proportionate share of DE's assets, excluding any assets that would produce income subject to gross basis withholding tax if directly held by USP. Fourth, FC is entitled to claim a credit under country Z tax law for the payment and recognizes a deduction for the $300 million contributed to DE under country Z law. The credit claimed by FC corresponds to more than 10% of USP's share (for U.S. tax purposes) of the foreign payment and the deductions claimed by FC correspond to more than 10% of the base with respect to which USP's share of the foreign payment was imposed. Fifth, FC is a counterparty because FC is considered to own equity of DE under country Z law and none of FC's stock is owned, directly or indirectly, by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, the United States and country X treat certain aspects of the transaction differently, including the proportion of equity owned in DE by USP and FC, and the amount of credits claimed by USP if the country Z payment were an amount of tax paid is materially greater than it would be if the country X tax treatment controlled for U.S. tax purposes such that FC, rather than USP, owned the class C stock. Because the payment to country Z is not an amount of tax paid, USP is not considered to pay tax under section 901. USP has $400 million of interest income.

Example 10. Loss surrender. (i) Facts. The facts are the same as in Example 9, except that the deductions attributable to the arrangement contribute to a loss recognized by FC for country Z tax purposes, and pursuant to a group relief regime in country Z FC elects to surrender the loss to its country Z subsidiary.

(ii) Result. The results are the same as in Example 9. The surrender of the loss to a related party is a foreign tax benefit that corresponds to the base with respect to which USP's share of the foreign payment was imposed.

Example 11. Joint venture; no foreign tax benefit. (i) Facts. FC, a country X corporation, and USC, a domestic corporation, each contribute $1 billion to a newly-formed country X entity (C) in exchange for stock of C. FC and USC are entitled to equal 50% shares of all of C's income, gain, expense and loss. C is treated as a corporation for country X purposes and a partnership for U.S. tax purposes. In year 1, C earns $200 million of net passive investment income, makes a payment to country X of $60 million with respect to that income, and distributes $70 million to each of FC and USC. Country X does not impose tax on dividends received by one country X corporation from a second country X corporation.

(ii) Result. FC's tax-exempt receipt of $70 million, or its 50% share of C's profits, is not a foreign tax benefit within the meaning of paragraph (e)(5)(iv)(B)(4) of this section because it does not correspond to any part of the foreign base with respect to which USC's share of the foreign payment was imposed. Accordingly, the $60 million payment to country X is not attributable to a structured passive investment

arrangement.

Example 12. Joint venture; no foreign tax benefit. (i) Facts. The facts are the same as in Example 11, except that C in turn contributes $2 billion to a wholly-owned and newly-formed country X entity (D) in exchange for stock of D. D is treated as a corporation for country X purposes and disregarded as an entity separate from its owner for U.S. tax purposes. C has no other assets and earns no other income. In year 1, D earns $200 million of passive investment income, makes a payment to country X of $60 million with respect to that income, and distributes $140 million to C.

(ii) Result. C's tax-exempt receipt of $140 million is not a foreign tax benefit within the meaning of paragraph (e)(5)(iv)(B)(4) of this section because it does not correspond to any part of the foreign base with respect to which USC's share of the foreign payment was imposed. Fifty percent of C's foreign tax exemption is not a foreign tax benefit within the meaning of paragraph (e)(5)(iv)(B)(4) because it relates to earnings of D that are distributed with respect to an equity interest in D that is owned indirectly by USC under both U.S. and foreign tax law. The remaining 50% of C's foreign tax exemption, as well as FC's tax-exempt receipt of $70 million from C, is also not a foreign tax benefit because it does not correspond to any part of the foreign base with respect to which USC's share of the foreign payment was imposed. Accordingly, the $60 million payment to country X is not attributable to a structured passive investment arrangement.

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(h) * * *

(2) Paragraph (e)(5)(iv) of this section applies to foreign payments that, if such payments were an amount of tax paid, would be considered paid or accrued under §1.901-2(f) on or after [**INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER**]. See 26 CFR 1.901-2T(e)(5)(iv) (revised as of April 1, 2011), for rules applicable to foreign payments that, if such payments were an amount of tax paid, would be considered paid or accrued before [**INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER**].

§1.901-2T [Removed].

Par. 5 Section 1.901-2T is removed.

Steven T. Miller

Deputy Commissioner for Services and Enforcement.

Approved: July 11, 2011

Emily S. McMahon

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