The Past and Future of the Foreign Tax Credit[1]

By Philip R. West and Amanda P. Varma

Philip R. West and Amanda P. Varma examine the complexity of the foreign tax credit.

Few issues in the international tax world, or the tax world more generally, have generated more attention recently than the foreign tax credit. It is easy to see why: the rules are complex, the issues are pervasive, the stakes are high and the policies animating the rules often conflict.

From the early days of the credit, fundamental issues arose, some of which are still unresolved today. Who is the taxpayer entitled to the credit? When does foreign law control in the credit calculation and when does U.S. law control? Under what circumstances should a literal application of the credit rules give way to overriding policy concerns? When is a tax payment voluntary? Section I considers these fundamental issues and provides a brief history of the credit.

More recently, these and other fundamental questions have been at the center of litigation, legislation and administrative guidance concerning perceived abuses in so-called "foreign tax credit generator" and "splitter" transactions, "covered asset acquisitions" and other transactions designed to bring back to the United States foreign taxes that are disproportionate to the income repatriated. Section II describes these recent developments.

At a basic level, recent foreign tax credit developments raise the fundamental question of (a) whether our system should encourage "cross-crediting" to mitigate inefficiencies of our foreign tax credit system such as our interest allocation rules (which, interestingly, were also introduced because of perceived abuses), and the inability to credit non–income taxes, or (b) whether our system is already too generous by rejecting what economists refer to as "national neutrality" (as distinct from capital export neutrality and capital import neutrality) and assuming that foreign taxes deserve a more favorable status than other business expenses, including state and local taxes, which merely give rise to deductions and not credits. These issues appear to be getting even more important as we enter into a broader corporate tax reform debate. That debate will force us to confront the fundamental direction we want to take on double tax mitigation and will raise numerous questions. Is our current system actually better than other countries' territorial systems because of the potential to cross-credit? If we adopt a territorial system that provides for less than a 100-percent exemption, should we even include a foreign tax credit? If so, how should it be designed? Although a full consideration of these issues is beyond the scope of this article, Section III poses these and other questions relevant to assessing the future of the foreign tax credit.

Overview of Foreign Tax Credit Rules

U.S. taxpayers are generally subject to U.S. tax on their worldwide income, but may be provided a tax credit for foreign income taxes paid or accrued.[2] The main purpose of the foreign tax credit is to mitigate the double taxation of foreign source income that

Philip R. West is Chair of the Tax Practice and a Partner in the Washington office of Steptoe & Johnson LLP, where he focuses mainly on international tax issues for both domestic and foreign clients.

Amanda P. Varma is an Associate at Steptoe & Johnson LLP in Washington, DC.

might occur if such income is taxed by both the United States and a foreign country.

A U.S. taxpayer may receive a "direct" foreign tax credit for foreign taxes that the taxpayer itself pays. In the case of a U.S. corporation that owns at least 10 percent of the voting stock of a foreign corporation, the taxpayer may be entitled to an "indirect" or "deemed" credit for the foreign taxes paid by that foreign subsidiary when foreign income earned by that subsidiary is distributed to the U.S. corporation as a dividend or included in the U.S. corporation's income under Subpart F.[3] In general, the foreign taxes deemed paid by the U.S. corporation is calculated by reference to the ratio of earnings distributed (or deemed distributed) to the U.S. corporation over the foreign subsidiary's total earnings and profits.

This section provides a basic overview of the foreign tax credit rules.[4] First, it provides a brief summary of the history of the foreign tax credit. Second, it considers who is the taxpayer entitled to the credit. Third, it summarizes which foreign taxes are creditable. Finally, it reviews how the amount of the credit is determined.

Brief History

When the U.S. federal income tax was introduced in 1913, taxpayers were permitted to deduct foreign taxes.[5] Congress enacted a foreign tax credit in the Revenue Act of 1918.[6] As Graetz and O'Hear describe:

> [B]ecause the United States insisted on taxing the worldwide income of its citizens, the pre-1918 arrangement permitted a form of double taxation, with foreign-source income being fully subject to taxation both at home and abroad. In 1913, when the American income tax was first implemented, tax rates were low and this double taxation may have been a comparatively minor nuisance. In 1918, however, with the world at war and tax rates inflating rapidly around the globe, international double taxation was becoming a far more series burden on Americans doing business or investing abroad. The top marginal rates on individuals in the United States reached 77 percent, and although the basic corporate rate was only 10 percent, an excess profits tax at rates from 8 to 60 percent also applied to many large companies. In such circumstances, additional layers of taxation from other nations were potentially confiscatory. Relief became a matter of some urgency.[7]

T.S. Adams, tax advisor to the Treasury Department and a key contributor to the early development of the United States' international tax system, later wrote: "In the midst of the war, when the financial burden upon the United States was greater than it had ever been, I proposed to the Congress that we should recognize the equities … by including in the federal income tax the so-called credit for foreign taxes paid … I had no notion … that it would ever receive serious consideration."[8]

In 1921, Congress enacted the foreign tax credit limitation, which remains a crucial aspect of our foreign tax credit regime and is described in further detail below.[9] The Revenue Act of 1921 also established source rules, which the 1918 Act had omitted and which are crucial to the operation of the foreign tax credit.

Since the introduction of the credit, U.S. tax rates had fallen while European tax rates remained higher. Congress was concerned that the unlimited foreign tax credit allowed taxpayers to offset U.S. tax on U.S. source income. For example, assume that a taxpayer earned $100 in Country A foreign source income and $100 in U.S. source income. The Country A foreign tax rate is 50 percent and the U.S. tax rate is 40 percent. Country A imposes $50 of tax on the $100 earned in Country A. The United States imposes $80 of tax on the taxpayer's worldwide income ($200 x 40%). Without a limit on the foreign tax credit, the taxpayer can credit $50 against its U.S. tax liability, resulting in U.S. tax of $30. The taxpayer's U.S. tax liability on U.S. source income (which otherwise would have been $40) has thus been reduced by $10. As Adams stated:

> [The unlimited foreign tax credit] is subject to this … rather grave abuse: If the foreign taxes are higher than our rate of taxes, that credit may wipe out taxes which fairly belong to this country … [W]e know of instances where big corporations whose income was derived largely from this country have had their tax wiped out, so far as this country is concerned, because the English tax rates are three times as high as ours.[10]

Under the "overall" foreign tax credit limitation enacted in 1921, a taxpayer could offset its overall U.S. tax liability by the ratio of its foreign source income over its worldwide income. Thus, in the example above, the taxpayer's foreign tax credit limitation is calculated as $80 (the taxpayer's U.S.

tax liability on worldwide income) multiplied by the ratio of $100 (the taxpayer's foreign source income) over $200 (the taxpayer's worldwide income). Thus, in the example, the taxpayer's foreign tax credit limitation is $40, and the taxpayer owes U.S. tax of $40.

Since 1921, Congress has modified the foreign tax credit limitation in various respects. In 1932, Congress required taxpayers to use the lesser of the foreign tax credit allowed under either the overall limitation or the new "per country" limitation.[11] Under a per country limitation, the foreign tax credit limitation calculation is applied separately with respect to each foreign country in which foreign taxes are paid, rather than to all foreign income and foreign taxes taken together.

In 1954, Congress repealed the overall limitation in favor of the per country limitation only.[12] In 1960, Congress provided taxpayers with an election (which was irrevocable unless the IRS consented) to use either the overall or per country limitation.[13] In 1962, Congress introduced a separate limitation for nonbusiness interest income.[14] The per country rule was repealed in 1976, leaving only the overall limitation.[15]

In the Tax Reform Act of 1986, Congress created additional limitations, requiring the foreign tax credit to be computed with respect to separate categories ("baskets") of income rather than countries.[16] In 2004, Congress reduced the number of "baskets" from nine to two and modified the interest expense allocation rules, which, as discussed below, are an important component of the foreign tax credit limitation calculation.[17]

Who Is the Taxpayer Entitled to the Credit?

Under Code Sec. 901(b)(1), U.S. citizens and U.S. corporations are entitled to a foreign tax credit for "the amount of any income, war profits, and excess profits taxes paid or accrued during the tax year to any foreign country or to any possession of the United States." U.S. noncitizen residents may also be entitled to a credit for such taxes.[18] In addition, certain nonresident aliens and foreign corporations engaged in a trade or business in the United States may be entitled to a credit, to the extent provided in Code Sec. 906, for foreign taxes imposed on imposed on income effectively connected with the conduct of a U.S. trade or business.[19] A partner in a partnership or beneficiary of an estate or trust may also be entitled to its proportionate share of foreign taxes paid or accrued by the partnership or estate or trust during the tax year.[20]

The taxpayer entitled to the credit is the taxpayer legally liable for the foreign tax under foreign law (the "technical taxpayer" rule). The technical taxpayer rule dates back to the Supreme Court's 1938 decision in *Biddle*[21] and has since been implemented in regulations.[22] In *Biddle,* a shareholder in a U.K. company claimed a foreign tax credit for U.K. taxes imposed on corporate earnings distributed to the shareholder. Under the U.K. tax system, the U.K. company paid tax on its earnings and its distributions to shareholders were grossed up to reflect the corporate tax paid.[23] In *Biddle*, the taxpayer claimed a foreign tax credit for the tax paid by the foreign corporation.

The statute at issue in *Biddle* provided a foreign tax credit for "income … taxes paid or accrued … to any foreign country." The Supreme Court stated that the "decision must turn on the precise meaning of the words in the statute which grants to the citizen taxpayer a credit for foreign 'income taxes paid.'" According to the court, "whether the stockholder pays the tax within the meaning of our own statute … must ultimately be determined by ascertaining from an examination of the manner in which the British tax is laid and collected what the stockholder has done in conformity to British law and whether it is the substantial equivalent of payment of the tax as those terms are used in our own statute."

The court determined that the corporation, and not the shareholder, was legally required to pay the tax under U.K. law. The court also observed that remedies for nonpayment ran against the corporation, not the shareholder, and that the shareholder could not be held liable for the tax in the event of the corporation's failure to pay. The court concluded that the shareholder could not be considered to have "paid" the tax, as that term was used in the U.S. tax law.

Under the current regulations, "[t]he person by whom tax is considered paid for purposes of [Code Secs. 901 and 903] is the person on whom foreign law imposes legal liability for such tax, even if another person (*e.g.*, a withholding agent) remits such tax."[24] Because this "technical taxpayer" rule looks to formal legal liability, it may lead to circumstances in which the taxpayer that is legally liable for the foreign tax is different from the taxpayer that takes the associated foreign income into account. The issues associated with this "splitting" of foreign taxes from foreign income, including the new provisions intended to combat this issue, are described below.

What Foreign Taxes Are Creditable?

Code Sec. 901 limits the foreign tax credit to foreign taxes imposed on "income, war profits or excess profits." Code Sec. 903 extends the credit to foreign taxes imposed "in-lieu-of" an income tax.

"Tax." In order to be creditable under either Code Sec. 901 or Code Sec. 903, a foreign levy must be a "tax."[25] A levy is a tax "if it requires a *compulsory* payment *pursuant to the authority of a foreign country to levy taxes*."[26] Thus, as described below, the taxpayer's payment of the tax must be compulsory and not voluntary.

The tax also must be levied by the country pursuant to its taxing authority, not some other authority—as a result, penalties, fines, interest and customs duties are not considered taxes.[27] In addition, a foreign levy is not a tax to the extent the person subject to the levy receives a "specific economic benefit" from the foreign country in exchange for a payment.[28]

"Compulsory Payment." Only compulsory payments are considered payments of tax. A payment is not compulsory to the extent that the amount paid exceeds the amount of liability under foreign law for tax.[29] The regulations provide that "[a]n amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax."[30] An interpretation or application of foreign law is not considered reasonable if the taxpayer has actual notice or constructive notice, such as a published court decision, that the interpretation or application is likely to be erroneous.[31] A taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts.

The taxpayer must also "exhaust[] all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment)."[32] A remedy is "effective and practical" only if the cost (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success.[33] A settlement by a taxpayer of two or more issues will be evaluated on an overall basis in determining whether an amount is compulsory.[34]

In the recent case *Procter & Gamble Co.*, a federal district court held that a taxpayer must initiate competent authority proceedings even where double taxation arises because of conflicting claims by two foreign countries, as opposed to between the United States and a foreign country.[35] Procter & Gamble ("P&G") claimed a credit for Japanese taxes paid in several tax years. In a later year, the Korean tax authorities determined that the income with respect to which the Japanese taxes had been paid was also subject to tax in Korea. The IRS disallowed P&G's claim for a foreign tax credit for the Korean taxes. The court held that "[a]lthough P&G was required to pay Korean tax, and was reasonably advised as to the legality and accuracy of the Korean claim by its Korean counsel, P&G failed to 'exhaust all effective and practical remedies including invocation of competent authority procedures available under applicable tax treaties … ' to reduce the tax liability owed to Japan." Although the IRS had challenged the creditability of the Korean tax and not the Japanese tax, the court determined that the Japanese payments were not compulsory and that P&G was entitled to a credit for only the payments made to Korea.

Not all failures to reduce foreign tax cause a payment to be considered voluntary. The taxpayer's failure to use options or elections to shift its liability to a different year or years does not result in a noncompulsory payment.[36] Further, "a taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax."[37]

In 2007, the Treasury and IRS issued proposed regulations providing that the fact that one foreign member of a U.S.-owned foreign group of corporations surrendered a loss to another foreign member of such group to reduce the second member's foreign tax would not make the foreign tax later paid by the first member non-compulsory.[38] These regulations have not been finalized, and because the issue of foreign "group relief" is also implicated by new Code Sec. 909, the issues is likely to be addressed in the forthcoming Code Sec. 909 regulations.

Code Sec. 901: Foreign Taxes Imposed on "Income, War Profits or Excess Profits"

Predominant character. In addition to being a tax, "the predominant character of that tax [must be] of an income tax in the U.S. sense" (the "predominant character" test) in order for the tax to be creditable under Code Sec. 901.[39] Two requirements must be satisfied to meet this test.

"Likely to reach net gain." The first requirement is that the foreign tax must be "likely to reach net gain in the normal circumstances in which it applies."[40] Three conditions must be satisfied for a tax to meet this net gain criterion. First, the tax must meet a "realization requirement." In general, this requirement is met where the tax is imposed upon or subsequent to the occurrence of events ("realization events") that would result in the realization under the U.S. tax law.[41] In certain cases, however, the realization requirement may be satisfied upon the occurrence of an event prior to realization or upon the occurrence of certain deemed distributions.[42] Second, the foreign tax must be imposed on the basis of gross receipts (or gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value).[43] Third, the tax must satisfy a "net income requirement"—the base of the tax must be computed by reducing gross receipts to permit recovery of significant costs and expenses.[44]

In companion decisions in *PPL Corp.*[45] and *Entergy*,[46] the Tax Court recently concluded that a 1997 windfall profits tax imposed by the U.K. government on certain former government-owned utilities is a creditable tax for purposes of Code Sec. 901. The government appealed the Tax Court's decision to the Court of Appeals for the Third (*PPL*) and Fifth Circuits (*Entergy*).[47] As described below, the Third Circuit reversed the Tax Court. The Fifth Circuit has not yet ruled (as of the date this is written).

After being privatized by the Conservative Party-controlled government in the early 1990s, the U.K. utilities became very profitable and "the public retained a strong feeling that the privatized utilities had unduly profited from privatization and that customers had not shared equally in the gains therefrom."[48] In 1997, the new Labour Party-controlled government announced a "windfall profits" tax on the companies. The tax was a one-time 23 percent tax on the "windfall," calculated as the difference between the then-current value of the company (determined by reference to average book profits of the company over the first four years following privatization multiplied by a price-to-earnings ratio of nine) and the value placed on the company upon privatization.

In the Tax Court, the IRS argued that only the windfall tax statutory language itself—which referred to a tax between the value of the company at two different points in time—could be considered. When only the statutory text was considered, the IRS argued, the tax was not likely to reach net gain because it failed the realization, gross receipts, and net income tests and thus did not satisfy the predominant character requirement. The taxpayer argued that extrinsic evidence of the purpose and effect of the tax should be considered in determining creditability. The taxpayer cited expert testimony that the windfall tax was, in substance, a tax on income, and that the tax could be restated algebraically to make clear that it operated as an excess profits tax imposed on excess profits in the relevant period at an approximately 51.7-percent rate.

The Tax Court looked to cases predating the current "predominant character" regulations (and cited in the preamble to those regulations), which considered the form and effect of the foreign taxes in determining creditability. The court, without explicitly applying the three tests of the regulations (realization, gross receipts and net income), concluded that the tax met the "predominant character" standard because it reached net gain in substance, stating that "a foreign levy [can] be directed at net gain or income even though it is, by its terms, imposed squarely on the difference between the two values."[49]

The Third Circuit in *PPL* reversed the Tax Court, holding that the windfall profits tax was not imposed on the basis of gross receipts and thus was not creditable.[50] The court concluded that "PPL's formulation of the substance of the U.K. windfall tax is a bridge too far … the tax base cannot be initial-period profit alone unless we rewrite the tax rate. Under the Treasury Department's regulation, we cannot do that." The court pointed to Reg. §1.901-2(b)(3)(ii), Example 3, which states that a tax with a base of 105 percent of gross receipts is not creditable because it "is designed to produce an amount that is greater than the fair market value of actual gross receipts." The court observed that a 20-percent tax levied on a base of 105 percent of gross receipts would be the equivalent of a 21-percent tax on 100 percent of gross receipts, but stated that the regulation did not allow any such reformulation. The court also stated that the approach of the pre-regulation cases considered by the Tax Court was in tension with the plain language of the regulations, which provides a three-part test for assessing whether a tax is likely to reach net gain. Although the pre-regulation cases were cited in the preamble to the regulations, the court "resolve[d] this tension in favor of the text of the regulation, which does not include the preamble."

Not a "soak-up tax." The second requirement under the predominant character test provides that a foreign tax is an income tax in the U.S. sense only to the extent that liability for the tax is not dependent on the availability of a credit for the tax in another country (*i.e.*, a "soak-up tax").[51] Thus, a foreign tax cannot meet the predominant character test when it is imposed only if and to the extent that the foreign tax would not be imposed on the taxpayer but for the availability of a credit.

Foreign Taxes Imposed "in-lieu-of" an Income Tax

Under Code Sec. 903, foreign taxes imposed "in-lieu-of" an income tax may also be creditable.[52] As under Code Sec. 901, the tax must first be a "tax" within the meaning of Reg. §1.901-2(a)(2) (described above). Further, the tax must be imposed as a substitution for an income tax or a series of income taxes otherwise generally imposed. In addition, the tax must not be a "soak-up tax," except that an in-lieu-of tax is not considered a soak-up tax to the extent of the lesser of (1) the amount of foreign tax that would not be imposed on the taxpayer, but for the availability of a credit or (2) the amount by which the foreign tax paid by the taxpayer exceeds the amount of foreign tax income that would have been paid by the taxpayer if it had instead been subject to the generally imposed income tax.[53]

What Amount of Foreign Taxes Is Creditable?

Credit Limited to Foreign Taxes "Paid or Accrued"

A foreign tax credit (under either Code Sec. 901 or Code Sec. 903) is allowed only to the extent that the creditable foreign tax is "paid or accrued." An amount of tax is not considered paid to the extent that "it is reasonably certain that an amount will be refunded, credited rebated, abated, or forgiven."[54]

An amount is also not considered paid or accrued to the extent (1) the tax is used, directly or indirectly, to provide a subsidy to the taxpayer, a related party or any party to the transaction or a related transaction; and (2) the subsidy is determined by reference to the amount of the tax or the base used to compute the tax. According to the regulations, a "subsidy" includes "any benefit conferred, directly or indirectly, by a foreign country to [the taxpayer, a related person, or party to the transaction or related transaction]. Substance and not form shall govern in determining whether a subsidy exists. The fact that the U.S. taxpayer may derive no demonstrable benefit from the subsidy is irrelevant in determining whether a subsidy exists."[55]

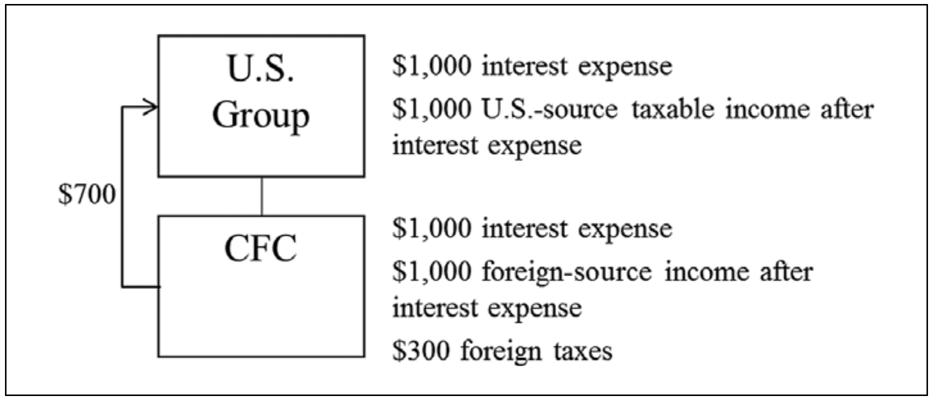
Calculation of Indirect (or Deemed) Foreign Tax Credit

U.S. corporations may be entitled to an "indirect" or "deemed paid" foreign tax credit for foreign taxes paid by foreign subsidiaries when it (a) receives a dividend from a foreign subsidiary or (b) has an income inclusion under Subpart F. The amount of foreign tax (which is determined under foreign law) brought up with a dividend or income inclusion is a function of the percentage of earnings brought up (or deemed brought up, in the case of Subpart F inclusions), which is a function of U.S. law.[56]

Foreign Tax Credit Limitation and Baskets

As mentioned above, the foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (computed under U.S. tax accounting principles). This limitation is computed by multiplying a taxpayer's total U.S. tax liability (prior to the foreign tax credit) in that year by the ratio of the taxpayer's foreign source taxable income in that year to the taxpayer's worldwide taxable income in that year.[57] Under current law, the limitation is applied separately to a "passive category income" basket and "general category income" basket.[58] Passive category income includes income that would be foreign personal holding company income under Code Sec. 954(c) (*e.g.*, dividends, interest and royalties) and other types of passive income.[59] Passive category income that is derived in the active conduct of banking, financing, or similar business or certain insurance business, however, is treated as general category income.[60] General category income includes all income except passive category income.[61]

Figure 1.



In order to determine foreign source taxable income in each basket for purposes of calculating the foreign tax credit limitation, a taxpayer must allocate and apportion deductions between U.S.-source gross income and foreign-source gross income.[62] The allocation and apportionment rules are complex but key to the operation of the foreign tax credit limitation. If expenses are overallocated to foreign income, the taxpayer's foreign tax credit limitation will be lower, resulting in less foreign taxes available to offset U.S. tax. If, on the other hand, expenses are underallocated to foreign income, the foreign tax credit limitation will be higher, resulting in more foreign taxes available to offset U.S. tax allocation and apportionment.

There are special rules for certain types of expenses, such as interest expense.[63] Under Code Sec. 864(e), an affiliated group must allocate and apportion its interest expense based on a fraction computed by reference to the assets (measured by fair market value or basis) of the entire group. Stock in foreign affiliates is treated as an asset of the affiliated group, but interest expense of foreign affiliates is not taken into account.

For example, in Figure 1, assume that a U.S. group has $1,000 of interest expense and $1,000 of U.S.-source taxable income after interest expense.[64] Half of the affiliated group's assets are foreign, including an investment in a controlled foreign corporation (CFC) that has $1,000 of interest expense and $1,000 of foreign-source income after interest expense. The CFC pays $300 in foreign taxes and pays a dividend of $700 to the U.S. group.

Because half of the U.S. group's assets are foreign, half of the $1,000 interest expense is allocated to foreign source income, while half is allocated against its U.S.-source income. As a result, the U.S. group has $500 in foreign source income ($700 plus $300 gross-up, minus $500 interest expense). The U.S. group's foreign tax credit limitation will be $175, which is calculated as 35 percent of its $2,000 worldwide income, multiplied by the fraction of foreign source income ($500) over worldwide income ($2,000).[65] Thus, $175 of the $300 of foreign taxes paid with respect to CFC's $1,000 earnings will be creditable, while $125 may be carried forward.[66]

In 2004, Congress enacted a worldwide interest allocation rule, under which interest expense and assets of foreign affiliates are taken into account.[67] The effective date of this rule (originally tax years beginning after December 31, 2008) has since been delayed until tax years beginning after December 31, 2020.[68] In sum, under a worldwide interest allocation, the interest expense of domestic members of worldwide affiliated group is allocated and apportioned to foreign-source income only to the extent that (1) the total interest expense of the worldwide affiliated group, multiplied by the ratio which the foreign assets of the group bear to the total assets of the group, exceeds (2) the interest expense of the foreign members of the worldwide group that would have been allocated and apportioned to foreign source income had the foreign members formed their own separate group.

Under worldwide interest allocation, all of the foreign taxes paid by CFC in the example would be creditable because no interest expense would be allocated to foreign-source income. This result is determined by making three calculations. First, the total interest expense of the worldwide affiliated group ($2,000) must be multiplied by the ratio which the foreign assets of the group bear to the total assets of the group (50 percent), which equals $1,000 in this case. Second, the interest expense of the foreign members of the worldwide group that would have been allocated and apportioned to foreign source income if the foreign members constituted their own group must be determined. In this case, CFC has $1,000 in interest expense. Assuming CFC has 100 percent foreign assets, CFC would have $1,000 of interest expense allocated to foreign source income if it were a separate group. Third, the result under the second calculation ($1,000) is subtracted from the result under the first calculation ($1,000). In this case, this final number is $0. Thus, no interest expense of the U.S. group is allocated to foreign-source income. The U.S. group will have $1,000 of foreign-source income ($700 dividend from CFC plus $300 gross-up). Its foreign tax credit limitation will be $350, which is calculated as $700 (35 percent of $2,000 worldwide income), multiplied by the fraction of foreign source income ($1,000) over worldwide income ($2,000). The U.S. group may fully credit the $300 in foreign taxes and has $50 of excess foreign tax credits.

Recent Developments

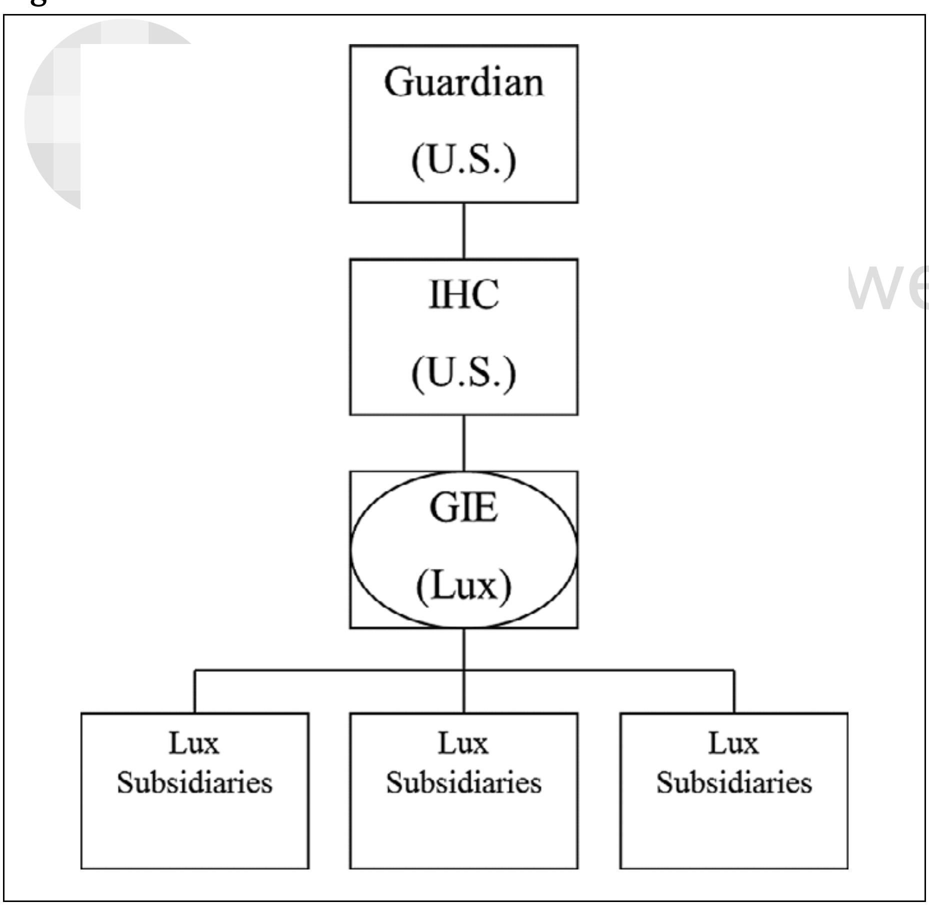
Foreign Tax Credit "Splitter" Issues and New Code Sec. 909

As mentioned above, foreign taxes are generally treated as paid by the person on whom foreign law imposes legal liability. Under this "technical taxpayer" rule, the person who has legal liability for a foreign tax can be different than the person who realizes the underlying income under U.S. tax principles, resulting in a separation or "splitting" of the foreign income to which the taxes relate. In some cases, this "splitting" can result in foreign taxes flowing up to the United States without the associated income being subject to tax in the United States. As described below, Congress enacted Code Sec. 909 in 2010 to address this issue.

Guardian *Litigation*

Guardian Industries Corp. concerned one arrangement (*see* Figure 2) involving such "splitting" of foreign income and taxes. In that case, Guardian was the parent of a U.S. consolidated group.[69] One of Guardian's U.S. subsidiaries, Interguard Holding Corp. ("IHC") owned Guardian Industries Europe ("GIE"), a disregarded entity, which in turn owned several Luxembourg subsidiaries. The Guardian consolidated group claimed that it was entitled to a direct foreign tax credit under Code Sec. 901for the Luxembourg taxes paid by GIE on behalf of itself and its subsidiaries.

Figure 2.



IHC, a U.S. corporation, did not itself pay any foreign taxes to Luxembourg. However, Guardian argued that GIE was legally liable for the taxes paid to Luxembourg by the members of GIE's Luxembourg consolidated group and that, because GIE was treated as a disregarded entity for U.S. tax purposes, those taxes should be treated as paid by IHC. The associated foreign income had not been taxed by the United States.

In the Court of Federal Claims, the government argued that, under Luxembourg law, GIE's subsidiaries should be considered legally liable for the taxes on the income that they had earned, even if GIE had paid taxes on their behalf. The government also argued that, under Luxembourg law, GIE and the Luxembourg subsidiaries were jointly and severally liable for the taxes and thus that, under Reg. §1.901-2(f)(3), each individual entity, not GIE, was liable for its own share of the tax. The court held that, under Luxembourg law, GIE was solely liable for the Luxembourg tax and thus that IHC was entitled to the foreign tax credits.

On appeal to the U.S. Court of Appeals for the Federal Circuit, the government did not challenge the Court of Federal Claim's determination that GIE and its subsidiaries were not jointly and severally liable under Luxembourg law for the taxes paid by GIE. Rather, the government argued that Reg. §1.901-2(f) required the Luxembourg tax to be allocated among the members of GIE's Luxembourg group in proportion to each member's share of the consolidated group taxable income. The government argued in its briefs:

> The Internal Revenue Code is not a high precision instrument. It lays down rules of general prescription. Circumstances sometimes arise when the statutory scheme fails to operate in accordance with the policies which motivated its creation. That such circumstances occur does not give us an excuse for failing to effectuate the general policies of the relevant Code provisions when it is possible to do so … The policy of reliving double taxation supports the Government's position that taxpayer is not entitled to the claimed tax credit. Taxpayer is not being taxed twice; it is undisputed that the income to which the foreign tax credits at issue relate—the income of GIE's subsidiaries—has never been taxed in the United States. To allow the credit here would facilitate a convenient scheme for avoiding the United States income tax.[70]

The Federal Circuit concluded that Reg. §1.901-2(f)(1) "on its face distinguishes between two situations. In one the person paying the tax is merely a withholding agent (or similarly, a remittance agent) and is paying the tax on behalf of another person who is legally liable for the tax. In the other the person paying the tax is the person with 'legal liability for such tax.'" The court determined that GIE should not be treated as a collection or remittance agent because, under Luxembourg law, GIE was liable for the tax.

The Federal Circuit stated that the government's appeal to the purpose of the foreign tax credit was "unavailing." According to the court, "United States taxation of the income of a disregarded foreign subsidiary does not depend on the provisions of foreign law as to which entity 'earns' the income … In any event, the regulation is clear on its face, and we must interpret it as written."

Other Examples

A variety of other situations may also result in the separation of creditable foreign taxes from the related foreign source income. For example, assume that a U.S. person owns an entity that is treated as a corporation for U.S. tax purposes and a passthrough entity under Country A law. Because Country A treats the owners of the entity (*e.g.*, the U.S. person) as being liable for the foreign taxes on the income earned by the entity, the U.S. person is the technical taxpayer. Because the entity is a corporation for U.S. tax purposes, however, the entity's foreign income has not been taken into account for U.S. tax purposes.

Separation of foreign taxes from foreign income can also occur in situations involving hybrid instruments, sale and repurchase transactions, and group relief.[71]

Proposed Legal Liability Regulations

In 2006, the Treasury and IRS proposed regulations (the "Proposed Legal Liability Regulations") amending the technical taxpayer regulations.[72] The Proposed Legal Liability Regulations purport to clarify the application of the legal liability rule under specific factual circumstances.[73] A modified version of these regulations, discussed below, was finalized in February 2012.

With respect to foreign consolidated-type regimes in which foreign tax is imposed on the combined income of two or more persons, including those where the members of the group are not jointly and severally liable for the group's tax (as was the case in *Guardian*), the proposed regulations provided that the foreign tax must be apportioned among all the members of the group *pro rata* based on the relative amounts of net income of each member as computed under foreign law.[74] A foreign tax would not be considered imposed on combined income, however, merely because foreign law (1) permitted one person to surrender a loss to another under a group relief regime, (2) required shareholders to include amounts in income attributable to corporate taxes under an integrated tax system, or (3) required shareholders to include in income amounts under an anti-deferral regime.[75]

The regulations also would have revised the technical taxpayer regulations to provide that a reverse hybrid (*i.e.*, an entity that is a corporation for U.S. tax purposes, but a flow-through for foreign tax purposes) is considered to have legal liability under foreign law for foreign taxes imposed on the owners of the reverse hybrid in respect of each owner's share of the reverse hybrid's income.[76] The reverse hybrid's foreign tax liability would be determined based on the proportion of the owner's taxable income (computed under foreign law) that is attributable to the owner's share of the reverse hybrid's income.

Although the proposed regulations addressed the situation in *Guardian*, they did not address all potential splitting arrangements. As a result, some believed that the issues were best addressed by legislation.

Code Sec. 909

In its 2010 budget proposal, the Obama Administration called for "adopt[ing] a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income."[77] The proposal was repeated in the Administration's 2011 budget proposal and emerged as a legislative proposal in a May 2010 extenders bill.[78] On August 10, 2010, Congress enacted such a "matching" rule as Code Sec. 909 in an unnamed act commonly referred to as the Education Jobs and Medicaid Funding Act of 2010 (the "EJMF Act").[79]

Under Code Sec. 909, where there is a "foreign tax credit splitting event" with respect to foreign income tax paid or accrued by the taxpayer, the foreign income tax is not taken into account for U.S. tax purposes before the tax year in which the related income is taken into account by the taxpayer. In the case of indirect credits, foreign income tax paid by a Code Sec. 902 corporation (*i.e.*, the foreign corporation with respect to which a U.S. corporation can claim an indirect foreign tax credit) as part of a splitting event is taken into account in the tax year in which the related income is taken into account by that Code Sec. 902 corporation or by a U.S. corporation that meets the requirements of Code Sec. 902(a) or (b) with respect to such 902 corporation.

The definition of "foreign tax credit splitting event" is broad and could reach a variety of situations in addition to those discussed above, such as disregarded payments, transfer pricing adjustments, contributions of property resulting in a shift of deductions and timing differences under U.S. and foreign law. Specifically, a "foreign tax credit splitting event" arises with respect to a foreign income tax if the related income is (or will be) taken into account for U.S. tax purposes by a "covered person."[80] A "covered person" is defined as any entity in which the payor holds, directly or indirectly, at least a 10 percent ownership interest (determined by vote or value); any person that holds, directly or indirectly, at least a 10 percent ownership interest (by vote or value) in the payor; and "any other person specified by the Secretary."[81]

Code Sec. 909 applies with respect to foreign income taxes paid or accrued in tax years beginning after December 31, 2010. For purposes of determining the indirect foreign tax credit with respect to dividends paid or Subpart F inclusions in such tax years, however, Code Sec. 909 also applies with respect to foreign income taxes paid or accrued by a Code Sec. 902 corporation in tax years beginning on or before December 31, 2010.

In Notice 2010-92,[82] the Treasury and IRS issued guidance addressing the applicability of Code Sec. 909 to foreign income taxes paid or accrued before December 31, 2010. The notice provided an exclusive list of arrangements treated as giving rise to foreign tax credit splitting events for purposes of applying Code Sec. 909 to pre-2011 taxes: (1) reverse hybrids; (2) foreign consolidated groups to the extent the taxpayer did not allocate the foreign consolidated tax liability among the members of the foreign consolidated group based on each member's share of the consolidated taxable income included in the foreign tax base under the principles of Reg. §1.901-2(f)(3); (3) certain group relief and loss-sharing regimes, but only in limited cases involving disregarded debt instruments; and (4) certain arrangements involving hybrid instruments. Any pre-2011 taxes that were not paid or accrued in connection with a pre-2011 splitter arrangement will not be subject to the new matching rule, along with pre-2011 split taxes deemed paid under Code Secs. 902 or 960 on or before the last day of the 902 corporation's last pre-2011 year; pre-2011 split taxes if either (1) the Code Sec. 902 corporation took the related income into account in a pre-2011 tax year or

(2) a Code Sec. 902 shareholder took the related income into account before the last day of the Code Sec. 902 corporation's last pre-2011 tax year, and pre-2011 split taxes paid or accrued in tax years before January 1, 1997.

Other Recently Enacted Foreign Tax Credit Provisions

In addition to Code Sec. 909, the EJMA Act included various other foreign tax credit-related offsets, including a limitation on foreign taxes deemed paid with respect to Code Sec. 956 inclusions, a provision denying foreign tax credits related to certain covered asset acquisitions, and the creation of a separate foreign tax credit limitation for certain items resourced under treaties.

Code Sec. 960(c) and Code Sec. 956 Inclusions

New Code Sec. 960(c) limits the foreign taxes deemed paid with respect to Code Sec. 956 investments in United States property. Under Code Secs. 951 and 956, a CFC's investment in United States property may be Subpart F income to the U.S. parent. Where the U.S. parent who is treated under Code Sec. 960 as having paid its *pro rata* share of the foreign taxes paid by the CFC on the earnings invested in U.S. property.

Before the EMJF Act, a lower-tier CFC's investment in U.S. property (*e.g.*, through a loan to the United States) would be taxed to the parent as if the lower-tier CFC paid a dividend directly to the parent, without regard to the earnings and profits and foreign taxes of intermediate CFCs. Thus, for example, where a second-tier CFC ("CFC 2") in a high-tax jurisdiction was owned by a first-tier CFC ("CFC 1") in a low-tax jurisdiction, a loan by CFC 2 to the U.S. parent by would result in higher foreign tax credits than if CFC 2 had distributed the same amount up the chain to the U.S. parent.

Under new Code Sec. 960(c), for acquisitions of U.S. property after December 31, 2010, the amount of foreign taxes deemed paid as a result of Code Sec. 956 inclusions is limited to the lesser of (1) the foreign taxes deemed paid with respect to the U.S. shareholder's Code Sec. 956 inclusion (without regard to the provision) (the "tentative credit") or (2) the hypothetical amount of foreign taxes deemed as computed under the provision (the "hypothetical credit"). The hypothetical credit is the amount of foreign taxes that would have been deemed paid if an amount equal to the Code Sec. 956 inclusion had been distributed through the chain of ownership that begins with the CFC that holds an investment in U.S. property and ends with the U.S. shareholder.

Covered Asset Acquisition

The EMJF Act also added new Code Sec. 901(m), which partially denies a foreign tax credit in situations when Code Sec. 338, Code Sec. 754 or a check-the-box election results in the creation of additional asset basis eligible for recovery for U.S. tax purposes where there is no corresponding increase in the basis of the assets for foreign tax purposes. A foreign tax credit is denied to the extent of the aggregate basis differences allocable to a particular tax year with respect to all relevant foreign assets divided by the income on which the foreign income tax is determined. To the extent that a foreign tax credit is disallowed, the disqualified portion may be allowed as a deduction.

The new provision is effective for covered asset acquisitions after December 31, 2010, but does not apply for covered asset acquisitions where the transferor and transferee are not related (under Code Sec. 267 and 707(b)) if the acquisition is: (1) made pursuant to a written agreement that was binding on January 1, 2011 and all times thereafter; (2) described in a ruling request submitted to the IRS on or before July 29, 2010; or (3) described in a public announcement or filing with the SEC on or before January 1, 2011.

Resourcing Under Treaties

Certain U.S. tax treaties provide a "resourcing" rule, under which a U.S. taxpayer may treat as foreign source any income that the other contracting state may tax under the treaty. Code Sec. 904(h)(1) treats as U.S.-source income earned through a majority U.S.-owned foreign corporation that is attributable to U.S. source income of the foreign corporation, treating such amounts as U.S. source. The rule generally prevents taxpayers from routing U.S.-source income through foreign corporations to increase the taxpayer's foreign source income for purposes of the foreign tax credit limitation.

In 1986, Congress enacted Code Sec. 904(h)(10) to coordinate Code Sec. 904(h)(1) with the treaty rule. Under Code Sec. 904(h)(1), if (1) any amount derived from a U.S.-owned foreign corporation would be treated as U.S-source income under Code Sec. 904(h)(1); (2) a U.S. treaty obligation would treat such income as arising from sources outside the United States; and (3) the taxpayer chooses the benefits of the coordination rule, then the amount will be treated as foreign source. However, for foreign tax credit limitation purposes, a separate limitation applies to such amount and the associated foreign taxes. This coordination rule applied only to amounts derived from a U.S.-owned foreign corporation, and not to amounts derived from a foreign branch or disregarded entity.

The EMJF Act added a new Code Sec. 904(d)(6) to extend the coordination rule to amounts earned through branches and disregarded entities. Under the new rule, a separate foreign tax credit limitation basket for any item of income and associated foreign taxes is created if (1) any item of income would be treated as U.S. source (without regard to a treaty re-sourcing rule); (2) under a treaty rule, such item is treated as foreign source; and (3) the taxpayer elects to claim the benefits of the treaty. Code Sec. 904(d)(6) is effective for tax years beginning after the date of enactment, *i.e.*, August 10, 2010. The rule was apparently motivated by a concern that taxpayers were using the resourcing rules to generate low-taxed resourced income to utilize excess foreign tax credits on high-taxed foreign source income.

"Pooling" Proposals

The Obama Administration has included a proposal to calculate indirect foreign tax credits on a "pooling basis" in its FY 2010, 2011 and 2012 budget proposals. The proposal is estimated to raise approximately $52 million over 10 years.[83] A similar proposal was included in then-House Ways and Means Committee Chair Rangel's Tax Reduction and Reform Act of 2007, although the Rangel bill proposal would require blending of foreign tax credits for both direct and indirect credits.[84]

The impetus behind both the Administration and Rangel proposal appears to be a concern that foreign tax credit "cross-crediting"—that is, having tax on income from a high-tax country credited against U.S. tax on income from a low-tax country—is improper. According to the Administration's 2012 budget proposal:

> The purpose of the foreign tax credit is to mitigate the potential for double taxation when U.S. taxpayers are subject to foreign taxes on their foreign-source income. The reduction to two foreign tax credit limitation categories, for passive category income and general category income under the American Jobs Creation Act of 2004, enhanced U.S. taxpayers' ability to reduce the residual U.S. tax on foreign-source income through "cross-crediting."

In September 2011, the Obama Administration released a deficit reduction plan to pay for its proposed "American Jobs Act" and raise the $1.5 trillion in savings pursuant to the Budget Control Act of 2011.[85] The deficit reduction plan included several of the Administration's recent international tax revenue provisions, including the foreign tax credit pooling proposal as well as proposals to defer the deduction of interest expense related to deferred income, create a new Subpart F category for "excessive returns" on outbound transfers of intangible property, "clarify" Code Sec. 936(h)(3)(B)(v) (to add goodwill, going concern, and workforce in place and allow the IRS to value intangibles on an aggregate basis and take into account realistic alternatives), limit "earnings stripping" by expatriated entities, and modify the foreign tax credit rules for dual capacity taxpayers and oil and gas income.

The Administration's release of draft legislative language for its deficit reduction provisions in September 2011 was the first time its pooling proposal was articulated in detail.[86] The Administration's proposal would create a new Code Sec. 910 and introduce several new concepts to the foreign tax credit calculation:

- "Current inclusion ratio": The ratio used to calculate the amount of foreign tax credits allowed under Code Sec. 910, generally calculated as (1) the sum of all dividends received from Code Sec. 902 corporations during the tax year plus Subpart F inclusions from Code Sec. 902 corporations (without regard to the Code Sec. 78 gross-up), over (2) the aggregate amount of post-1986 undistributed earnings.[88]
- "Suspended post-1986 foreign income taxes": The portion of the aggregate amount of post-1986 foreign income taxes[87] for any tax year not allowed as a credit due to the pooling mechanism.

Under proposed Code Sec. 910(a), the amount of foreign taxes deemed paid under Code Sec. 902 or

960 and allowed as a credit "shall not exceed the amount which bears the same ratio to the sum of the aggregate amount of post-1986 foreign income taxes for that tax year and the suspended post-1986 foreign income taxes as the current inclusion ratio." Suspended post-1986 foreign income taxes would be allowed as a credit under Code Sec. 901 in future years to the extent the amount of the post-1986 foreign taxes deemed paid in that year was less than the Code Sec. 910 limitation. Suspended foreign income taxes allowed as a credit in a subsequent year would be treated as deemed paid by the U.S. corporation in that subsequent year. The Code Sec. 910 limitation would be applied separately for each foreign tax credit basket. .

Code Sec. 910(f) would provide the Treasury with authority to "issue such regulations or other guidance as is necessary or appropriate to carry out the purposes of this section," including guidance for the proper application of Code Sec. 910 to: "(1) the treatment of certain corporations that otherwise would not be members of the affiliated group as members of the affiliated group for purposes of this section; (2) a taxpayer's share of a deficit in earnings and profits of a Code Sec. 902 corporation, (3) changes in ownership of a section 902 corporation, and (4) the treatment of amounts taken into account under section 960."

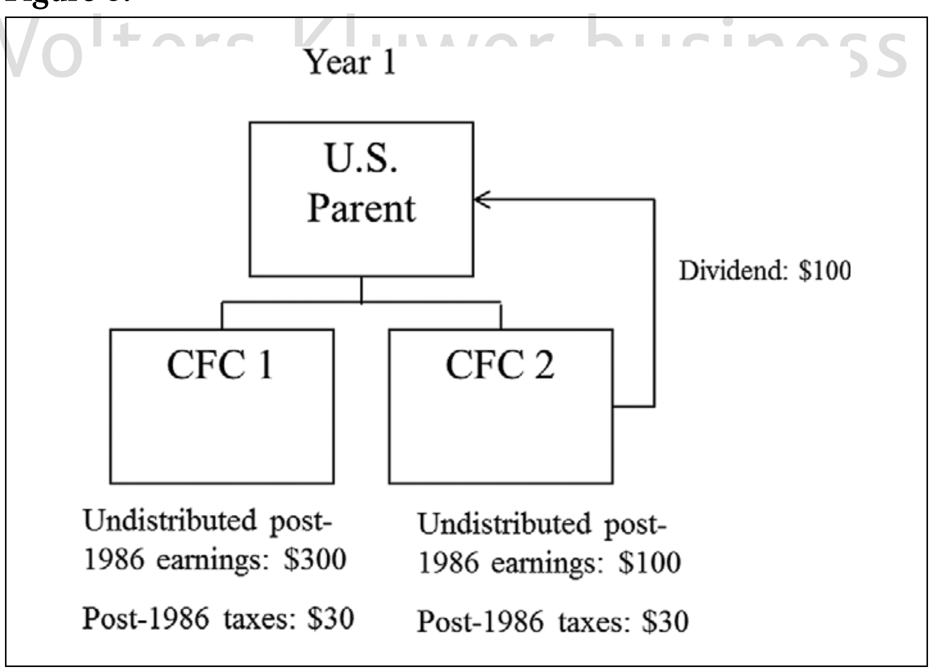
To illustrate the application of proposed Code Sec. 910, in Figure 3, assume that a U.S. parent corporation owns two CFCs. At the close of Year 1, CFC 1 has $300 of post-1986 earnings and profits and $30 of post-1986 foreign taxes. CFC 2 has $100 of post-1986 earnings and profits and $30 of post-1986 foreign taxes. In Year 1, CFC 2 pays a dividend of $100 to U.S. Parent.

U.S. Parent's deemed paid foreign tax credit may not exceed the aggregate amount of post-1986 foreign taxes ($30 foreign taxes of CFC 1 plus $30 foreign taxes of CFC 2) and suspended post-1986 taxes ($0), multiplied by the fraction that is (1) the sum of all dividends and Subpart F inclusions with respect to Code Sec. 902 corporations in the tax year ($100) over (2) the aggregate amount of post-1986 undistributed earnings ($300 earnings of CFC 1 plus $100 earnings of CFC 2). Thus, U.S. Parent's deemed paid foreign tax credit may not exceed $15 ($60 multiplied by $100/$400). Without Code Sec. 910, U.S. Parent's deemed paid Code Sec. 902 foreign tax credit would have been $30. As a result, U.S. Parent has $15 in "suspended post-1986 foreign income taxes" because only $15 out of the $30 otherwise allowable under Code Sec. 902 is allowed under Code Sec. 910.

Year 2, in Figure 4, CFC 1 earns $30 and pays $1 in foreign tax. As a result, CFC 1's undistributed post-1986 earnings are $330 and its post-1986 foreign taxes are $31. CFC 2 earns $10 and pays $3 in foreign tax. As a result, CFC 2's undistributed post-1986 earnings are $10 and its post-1986 foreign taxes are $3. CFC 1 pays a dividend of $100.

In Year 2, U.S. Parent's deemed paid foreign tax credit may not exceed the aggregate amount of post-1986 foreign taxes ($31 foreign taxes of CFC 1 plus $3 foreign taxes of CFC 2) and suspended post-1986 taxes ($15 from Year 1), multiplied by the fraction that is (1) the sum of all dividends and Subpart F inclusions with respect to Code Sec. 902 corporations in the tax year ($100) over (2) the aggregate amount of post-1986 undistributed earnings ($330 earnings of CFC 1 plus $10 earnings of CFC 2). Thus, U.S. Parent's deemed paid foreign

Figure 3.



tax credit may not exceed $14 ($49 multiplied by $100/$340). In the absence of Code Sec. 910, U.S. Parent would have been deemed to have paid $9 ($31 multiplied by $100/$330). That $9 will be creditable, along with $5 of the $15 suspended post-1986 foreign taxes from Year 1.

The pooling proposal has been criticized on several fronts. Some have argued that the proposal overrides the United States' tax treaties, which generally provide that the United States will provide a credit for taxes imposed by the other contracting state on the profits out of which the dividend is paid. According to one commentator, the proposal is inconsistent with this treaty obligation because it "would not provide [a foreign tax credit] for the contracting state's tax on the resident company's profits out of which the dividend is paid. The allowable amount of [foreign tax credits] would instead be limited to an amount measured by reference to the distributed and undistributed [earnings and profits] of all foreign subsidiaries (not limited to items comprising the contract state company's distributed and undistributed [earnings and profits]) and not limited to foreign subsidiaries located in jurisdictions with which the United States has an income tax treaty."[89]

Others have argued that the proposal would exacerbate the "lock-out" effect, under which corporations keep foreign earnings offshore to avoid U.S. tax upon repatriation.[90] As Martin Sullivan writes "U.S. corporations would always pay U.S. tax on repatriations if their average foreign tax rate was less than the U.S. tax rate. In most cases, the rate of this new U.S. tax would be the excess of the U.S. rate over the average foreign tax rate. The new penalty would apply to all dividend distributions to the United States even if the distributions were from high-tax countries."

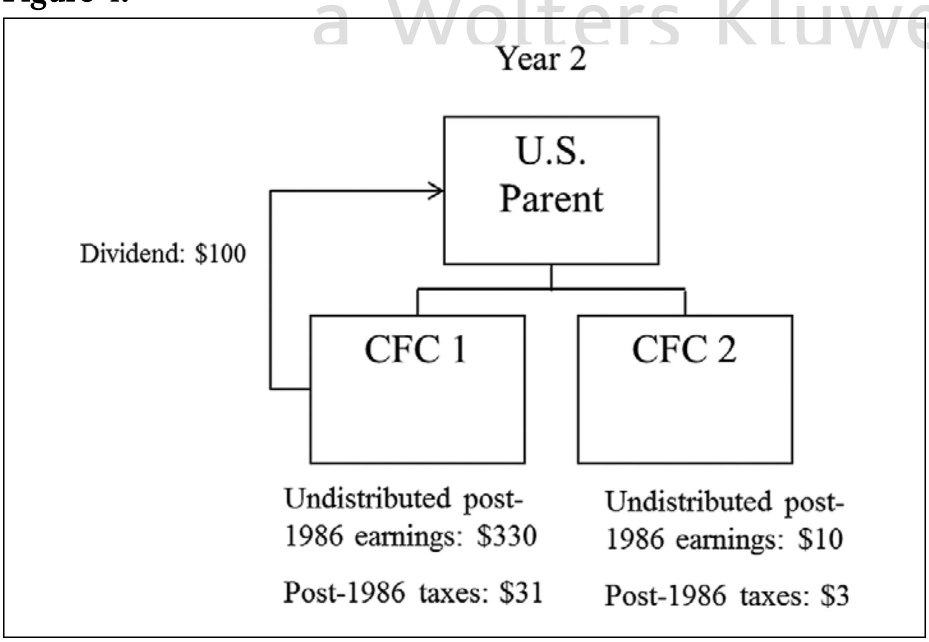
Foreign Tax Credit "Generator" Transactions

Administrative Guidance

In 1998, the Treasury and IRS attempted to address certain foreign tax credit arbitrage transactions in Notice 98-5.[91] That notice proposed to apply an economic profit test to disallow credits for two types of transactions (transactions transferring a foreign tax liability through the acquisition of an asset that generates an income stream subject to foreign gross basis taxes and cross-border tax arbitrage transactions permitting the duplication of tax benefits) if the reasonably expected economic profit from the transaction was insubstantial compared to the value of the credits sought. That guidance was withdrawn in Notice 2004-19, although the Treasury and IRS stated that they "remained concerned about transactions that involve inappropriate foreign tax results."[92]

The Treasury and the IRS have continued to focus on structured arrangements that may involve "inappropriate foreign tax results." On July 13, 2011, the Treasury Department and IRS issued final regulations (T.D. 9535)[93] addressing foreign tax credit "generator" transactions. The final regulations adopt 2008 temporary regulations (T.D. 9416)[94] with some modifications.[95] Under the final regulations, amounts paid to a foreign taxing authority that are attributable to a "structured passive investment arrangement" (SPIA) are not treated as an amount of tax paid for foreign tax credit purposes. An SPIA is defined as an arrangement meeting six specified conditions. The six

Figure 4.



conditions can be met even if they are not part of a plan or series of related transactions.

The first condition is that the arrangement utilizes an entity where (1) substantially all of the entity's gross income is attributable to passive investment income and substantially all of the entity's assets are held to produce such passive investment income (with certain exceptions)[96] and (2) there is a foreign payment attributable to the income of the entity.[97]

The second condition is that a person (a "U.S. party") would be eligible to claim a credit under Code Sec. 901(a) (including a credit for foreign taxes deemed paid under Code Sec. 902 or 960) for all or a portion of the foreign payment if the foreign payment were an amount of tax paid.

The third condition is the U.S. party's share of the foreign payment(s) 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 Code Sec. 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.

The fourth condition is that the arrangement is reasonably expected to result in a tax benefit to a counterparty or related person under the laws of the foreign country. If the foreign tax benefit available is a credit, the condition is met if 10 percent or more of the U.S. party's share of the foreign payment. The condition is met with respect to other types of foreign tax benefits, such as exemptions, deductions and exclusion of losses if they correspond to 10 percent or more of the foreign base with respect to which the U.S. party's share of the foreign payment is imposed.

The fifth condition is that the arrangement include a person that, under the 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. Dual citizens or U.S. residents generally subject to U.S. tax on worldwide income are not treated as counterparties.

The final condition is 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.

Litigation

There are currently several pending cases involving transactions generating foreign tax credit results the IRS finds inappropriate (so-called foreign tax credit "generator" transactions). The first of these cases to reach a decision is *Pritired 1, LLC & Principal Life Insurance Co.*, in which the United States District Court for the Southern District of Iowa held in favor of the government.[98]

In the transaction at issue, Principle Life partnered with Citibank to create a partnership ("Pritired"), which invested in Class B shares and Perpetual Certificates issued by two French entities (collectively, the "SAS") that had been created by French investment banks. The SAS was intended to be treated Pritired contributed $300 million in cash in exchange for $291 million in Perpetual Certificates, which were stapled to $9 million of Class B shares. The Perpetual Certificates bore a floating interest rate of three-month LIBOR plus one percent. Pritired and the SAS also entered into a swap in which Pritired exchanged the payments on the Perpetual Certificates for payments of LIBOR plus approximately 500 basis points, less French income taxes.

The SAS invested in an existing portfolio of debt securities from the French banks, as well as other securities for which the French banks were counterparties. There was a contractual interest rate floor with respect to SAS's earnings, so that SAS was guaranteed a minimum level of earnings (and Pritired a minimum level of foreign tax credits), even if LIBOR fell.

The SAS paid French income taxes on the income from the investments. These French taxes were specially allocated between the owners of the SAS, primarily to Pritired. As a 50-percent partner in Pritired, Principal Life claimed a credit its share of these foreign taxes.

The Court disallowed the foreign tax credits. First, the court found that the transaction is properly characterized as a loan. Therefore, the SAS was not a partnership, Pritired was not a partner in the SAS, and Pritired's partners could not claim foreign tax credits for French taxes paid. In making this determination, the court evaluated the debt and equity characteristics of the Perpetual Certificates and B Shares, focusing on (a) characterization (*i.e.*, form); (b) market risk; (c) credit risk; and (d) voting rights. The court determined that, although the B Shares were labeled as equity, those shares were tied to the Perpetual Certificates, which the parties labeled as debt in certain circumstances and equity in others. The court concluded that the characterization factor was mixed. With respect to market risk, the court observed that the transaction had a certain expected maturity date and was expected to provide "predicable, stable returns." Thus, the court determined that the market risk factor was more consistent with debt treatment than equity treatment. On the credit risk factor, the court determined that the Perpetual Certificates had ongoing payment attributes and liquidation priorities more akin to debt, while the B shares had payment attributes and liquidation priorities more akin to equity. With respect to voting rights, the court found that the Perpetual Certificates had no voting rights, which was consistent with debt treatment. Although the B shares had certain voting rights, the court found that those voting rights "were more in the form of controls seen in debt covenants." After considering the characteristics of both the Perpetual Certificates and B shares, the court concluded that they both "had attributes that more closely resembled debt rather than equity" and thus Pritired's investment was in the form of debt rather than equity.[99]

The court also held that the transaction lacked economic substance. Applying the Eight Circuit's conjunctive economic substance test, the court determined that the taxpayers had no realistic opportunity to earn a profit independent of the foreign tax credits and determined that the taxpayers did not expect to earn a meaningful return without the foreign tax credits. The court rejected Principal Life's argument that it should be permitted to rely on examples in Notice 98-5, which had considered as a factor in determining whether an arrangement was abusive the expected economic profit from the arrangement when compared to the foreign tax credits generated. The court stated, "By its very terms, Pritired was engaging in the behavior Notice 98-5 intended to address."

The Future of the Foreign Tax Credit

Analysis of Recent Developments

The foreign tax credit-related changes in the EJMF Act appear motivated by Congress's desire to raise revenue by foreclosing specific planning opportunities perceived as undesirable. Code Sec. 909, however, goes further than several of the other provisions by adding a new general principle to the foreign tax credit rules—that providing a credit for foreign taxes paid should be conditioned on the income associated with those foreign taxes also being taken into account. Despite the Treasury and IRS's recent desire to promote this principle through the *Guardian* litigation and the proposed technical taxpayer regulations, it has in fact been a central feature of the foreign tax credit rules that, because foreign taxes are computed under foreign law, and the amount of foreign tax brought up with a dividend is a function of the percentage of earnings brought up, not the absolute amount of earnings brought up (with earnings computed under U.S. law), there is no necessary correlation between the foreign tax available as a credit and the includable income that brings with it those credits. Put more simply, one dollar of income can bring up $1 million of foreign tax, and it is central to the calculation of the credit that this result can be obtained.

Since *Biddle* and the promulgation of the technical taxpayer regulations, legal liability under foreign law has been central to determining who is the taxpayer entitled to the credit. As the U.S. Court of Appeals for the Federal Circuit recognized in *Guardian*, prior case law stands for the proposition that entitlement to the credit depends on "which entity bore the imposition of the tax" and not "which entity 'earned' the income."[100] Code Sec. 909 undercuts the administrative convenience of the technical taxpayer rule, with the new matching requirement adding considerable complexity. Code Sec. 909 also requires foreign taxes to be matched with the related income as determined under U.S. tax principles rather than foreign law principles, a seeming change from the IRS's general approach. As one commentator has noted, "[t]he IRS has previously tried to match [foreign tax credits] with the person treated as owning the income for foreign law purposes, and has declined to match credits to the person that U.S. tax law treats as recognizing the foreign-source income. Code Sec. 909 therefore represents a major departure from the IRS's historical approach."[101]

Code Sec. 909 is viewed by some as furthering the purpose of the foreign tax credit. Under this view, "splitter" arrangements are contrary to the purpose of mitigating double taxation because a credit for foreign taxes may be allowed without the underlying foreign income being subject to tax in the United States.[102] But given that (1) the foreign tax credit rules often come out on the side of administrability rather than policy purity (*e.g.,* the credit limitation is applied with respect to baskets, not items) and (2) matching of taxes and income has not historically been considered central to achieving the purpose of the foreign tax credit, why did matching motivate a new statutory provision changing the historic operation of the credit?

One major driver appears to have been the promulgation of the check-the-box regulations, which have created more opportunities to split foreign taxes from the associated income (though Code Sec. 909 goes far beyond addressing check-the-box planning). And perhaps more importantly, at the time Code Sec. 909 was enacted, splitting arrangements were viewed as exploiting "loopholes," the closing of which would generate necessary revenue, rather than the result of long-standing rules.[103]

Viewed in this light, Code Sec. 909 seems less of an attempt to further better foreign tax credit "policy" and more of an attempt to target perceived inappropriate planning opportunities to raise revenue. The other foreign tax credit provisions in the EJMF Act, as well as the Obama Administration's pooling proposal, are consistent with this focus.

Still, when viewed through the long lens of the total history of the credit, it is difficult to say that the recent enactments represent some deviation from a historic trend (in terms of the strictness of the credit). Time and again, we have seen the pendulum swing from planning that is perceived by the government to be overly aggressive, to regulation and legislation that is perceived by the taxpayer community as overly aggressive. Overall, the rules have been narrowed and broadened in different generations, and it is difficult to say that they have been on a long-term trend in either direction. More recently, some might argue that the reduction of baskets in 2004 was a significant broadening of the credit. Others, however, have argued that the reduction simply eliminated numerous little-used baskets and thus was not a significant development. (The elimination of the financial services basket, however, is generally acknowledged to have had a significantly favorable impact on the credit position of financial institutions.) Thus, it is difficult to say that there is any historic, or even recent, foreign tax credit trend by which to measure the provisions passed in 2010.

The Foreign Tax Credit and Tax Reform

Debate over international tax reform has increased in recent years. Some have argued that the United States should eliminate deferral and tax foreign income earned by foreign subsidiaries of U.S. companies on a current basis, but provide a foreign tax credit for foreign taxes paid. On the other hand, others have argued that the United States should move to an exemption (or "territorial") system, under which active foreign income would not be subject to U.S. tax. One major argument has been that doing so would make U.S. businesses more competitive abroad. Others, however, have argued that the cross-crediting allowed by the current system is actually more generous to taxpayers than an exemption system. For example, the American Bar Association's Task Force on International Tax Reform states:

> Cross-crediting of excess foreign taxes on high foreign-taxed foreign income against U.S. tax on low foreign-taxed foreign income concedes the residual U.S. tax on such low-taxed foreign income to the high-tax foreign country (not to the source country imposing a low foreign tax). A foreign tax credit system that allows excessive crediting of foreign taxes is more generous to investment in high-tax countries than an exemption system. This is because under an exemption system excess tax credits from high-tax countries cannot be used as credits against tax on other income. The U.S. tax rules already allow substantial crosscrediting and this will be increased after the AJCA's reduction in foreign tax credit limitation categories becomes effective in 2008. Cross-crediting is one of several reasons why the U.S. rules are more generous to investment in high-tax countries than under an exemption regime.[104]

In the purest form of an exemption system, under which foreign income is never subject to domestic tax, a foreign tax credit would not be necessary. In practice, however, such an exemption system does not exist.[105] Rather, countries generally provide an exemption only for certain types of foreign income and/or may tax certain income on a current basis.

On October 26, 2010, House Ways and Means Chairman Camp (R-MI) released a discussion draft that would reform the United States' international tax system, including by adopting a territorial tax system.[106] The draft would provide a deduction equal to 95 percent of foreign-source dividends received by a 10 percent U.S. corporate shareholder from a CFC. Subpart F would be retained. A transition rule would deem all existing offshore earnings to be repatriated over eight years (regardless of whether those earnings are actually repatriated) and would apply an 85 percent dividends-received deduction (*i.e.*, a 5.25 percent rate) to such deemed repatriated earnings.[107]

Consistent with the reality that the foreign tax credit remains important even an exemption system, the foreign tax credit remains, albeit in modified form, in the Way and Means discussion draft. Code Sec. 901 (the direct credit) would not be altered. However, because the 95 percent dividends-received deduction would become the main mechanism for alleviating potential double taxation on offshore earnings repatriated to the United States actual and deemed, Code Sec. 902 (the indirect credit available on dividend distributions from foreign subsidiaries to the United States) would eliminated, including for companies that did not qualify for the 95 percent dividends-received deduction (such as noncontrolled 10/50 companies). A foreign tax credit would be allowed, however, for the taxable portion of the offshore earnings deemed repatriated under the transition rule. The discussion draft would also eliminate the foreign tax credit baskets, as well as the Code Sec. 909 foreign tax credit "splitter" rule.

Because the proposal retains Subpart F, the deemed paid foreign tax credit remains for Subpart F income inclusions. The credit for such income would be restricted to foreign taxes "attributable to the Subpart F inclusion" and, for purposes of calculating foreign source income under the foreign tax credit limitation, only directly allocable deductions would be subtracted from gross foreign source income. According to the Technical Explanation of the discussion draft, "directly allocable deductions" are "deductions that are directly incurred as a result of the activities that produce the related foreign source income."[108] Thus, "stewardship expenses, general and administrative expenses, and interest expenses are not considered directly allocable deductions."[109]

One lesson from the discussion draft appears to be that, even if we move to a territorial system, the foreign tax credit would not become irrelevant. Although complexity would be reduced in some respects (such as through the elimination of baskets and the repeal of Code Sec. 909), complexity might be increased in other respects, because the credit would apply to certain income, would not apply to other income, and would apply in part to yet a third category of income. Thus, even if a territorial system were adopted, it appears that the foreign tax credit will continue to be a feature of our tax system for the foreseeable future and that it will continue to carry at least some complexity.

Conclusion

Although the foreign tax credit has been subject to various changes in the past 90 years, the history of the credit does not appear to point to one clear policy direction. It has at times been broadened, and at other times narrowed, with the changes sometimes driven by strong policy considerations (with pursuit of the same purpose sometimes leading in different directions), sometimes driven by administrability considerations, and at other times driven by the narrower compliance and revenue concerns of the day. And it has at times been simplified, but it has more often been made more complex, with the most recent changes tending toward further complexity.

The recent foreign tax credit changes arguably alter a fundamental feature of the credit and/or make the credit more complex. In the face of these criticisms, however, it must also be acknowledged that these recent changes have been invited by planned transactions, and are not inconsistent with any long term trend of relaxation in the credit rules.

A learned commentator has recently used some of these and other arguments to make the case that the credit should be abandoned altogether as the worst of all worlds: a complex regime that furthers bad policy.[110] As with most things, however, until a consensus forms around a better alternative, we will be faced with the daunting task of improving what we have.

Endnotes

1 This paper is based on a presentation made at the 2011 University of Chicago Tax Conference.

2 Alternatively, a taxpayer may deduct foreign taxes. In most cases, a foreign tax credit will be more advantageous than a deduction because the credit allows the taxpayer to reduce its U.S. tax liability on a dollar-by-dollar basis.

3 *See* Code Secs. 901, 902, 960, 1295(f).

4 In general, we focus herein on the foreign tax credit provisions and issues relevant to

U.S. corporations.

[5] Revenue Act of 1913, ch. 15, 38 Stat. 144.

[6] Revenue Act of 1918, ch. 18, 40 Stat. 1057. *See* generally Michael J. Graetz and Michael M. O'Hear, *The 'Original Intent' of U.S. International Taxation*, 46 Duke L.J. 1021 (1996).

[7] *See* Graetz and O'Hear, *supra* note 6.

[8] Thomas S. Adams, *International and Interstate Aspects of Double Taxation*, 22 Nat'l Tax Ass'n Proc. 193, at 197 (1929).

[9] Revenue Act of 1921, 42 Stat. 227.

[10] Internal Revenue: Hearings Before the Committee on Finance of the United States Senate on H.R. 8245, 67th Cong. 256 (1921).

[11] Revenue Act of 1932, ch. 209, §131(b), 47 Stat. 169, 211.

[12] Internal Revenue Code Act of 1954 (P.L. 83-591), ch. 736, §904, 68A Stat. 3, 287-88.

[13] Revenue Act of 1960 (P.L. 86-780), §1(a), 74 Stat. 1010, 1010.

[14] Revenue Act of 1962 (P.L. 87-834), 76 Stat. 960.

[15] Tax Reform Act of 1976 (P.L. 94-455), sec. 1031, §904, 90 Stat. 1610, 1620-24. In 1976, Congress also enacted the overall foreign loss (OFL) recapture rules of section 904(f), under which foreign source losses that offset U.S. source income in one year are recaptured in a later year by recharacterizing foreign source income earned in the subsequent year(s) as U.S. source income.

[16] Tax Reform Act of 1986 (P.L. 99-514).

[17] American Jobs Creation Act of 2004 (P.L. 108-357).

[18] Code Sec. 901(b)(3).

[19] Code Sec. 901(b)(4).

[20] Code Sec. 901(b)(5).

[21] *M.D. Biddle,* SCt, 38-1 ustc ¶9040, Ct D 1303, 302 US 573, 58 SCt 379, 1938-1 CB 309.

[22] Reg. §1.901-2(f)(1).

[23] If the shareholder's income exceeded a certain amount, the shareholder was also subject to an additional surtax. That surtax was not at issue in the case.

[24] Reg. §1.901-2(f)(1).

[25] Reg. §1.901-2(a)(1)(i).

[26] Reg. §1.901-2(a)(2)(i) (emphasis added).

[27] *Id.*

[28] *Id.* A "specific economic benefit" is defined in the regulations as "an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general." Reg. §1.901-2(a)(2)(ii)(B). A person who is the subject of a levy and receives a specific economic benefit from the foreign government is considered a "dual capacity taxpayer" and is subject to special rules in Reg. §1.901-2A. Reg. §1.901-2(a)(2)(ii)(A).

[29] Reg. §1.901-2(e)(5)(i).

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] *Procter & Gamble Co.*, 106 A.F.T.R.2d 2010-5311 (S.D. Ohio 2010).

[36] *Id.*

[37] *Id.*

[38] REG-156779-06, 72 Fed. Reg. 15,081 (Mar. 30, 2007); *see also* Notice 2007-95, 2007-2 CB 1091 (providing that the proposed noncompulsory regulation would be effective for tax years beginning on or after the publication of final regulations, but that taxpayers could rely on the proposed regulations for tax years ending on or after March 29, 2007, and before the issuance of final regulations).

[39] Reg. §1.901-2(a)(1)(ii).

[40] Reg. §1.901-2(a)(3).

[41] Reg. §1.901-2(b)(2)(i)(A).

[42] Reg. §1.901-2(b)(2)(i)(B)-(C); Reg. §1.901-2(b)(2)(ii).

[43] Reg. §1.901-2(b)(3).

[44] Reg. §1.901-2(b)(4).

[45] *PPL Corp. and Subsidiaries*, 135 TC 304, Dec. 58,325 (2010).

[46] *Entergy Corp. & Affiliated Subsidiaries*, 100 TCM 79, Dec. 58,288(M), TC Memo 2010-166.

[47] *PPL Corp.*, No. 11-1069 (3d Cir. December 22, 2011); *Entergy Corp.*, No. 10-60988 (5th Cir).

[48] *Supra* note 45*,* at 309–310.

[49] *Id.* at 339.

[50] The court also stated, in a footnote, that the tax also failed the realization requirement.

[51] Reg. §1.901-2(c).

[52] Reg. §1.903-1(a). According to the regulations, "[t]he foreign country's purpose in imposing the foreign tax (*e.g.,* whether it imposes the foreign tax because of administrative difficulty in determining the base of the income tax otherwise generally imposed) is immaterial. It is also immaterial whether the base of the foreign tax bears any relation to realized net income. The base of the tax may, for example, be gross income, gross receipts or sales, or the number of units produced or exported." *Id.*

[53] Reg. §1.903-1(b)(2).

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

[55] Reg. §1.901-2(e)(3)(ii). The regulations provide that the use of an official foreign government exchange rate converting foreign currency into dollars where a free exchange rate also exists is not a subsidy if certain conditions are met. Reg. §1.901-2(e)(3)(iii).

[56] Reg. §1.902-1(a)(9).

[57] Code Sec. 901, 904.

[58] Code Sec. 904(d). Prior to the American Jobs Act of 2004, there were generally nine foreign tax credit baskets: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled Code Sec. 902 corporations, (6) certain dividends from domestic international sales corporations or former domestic international sales corporations, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from foreign sales corporations or former foreign sales corporations, and (9) any other item.

[59] Code Sec. 904(d)(2)(A)(i).

[60] Code Sec. 904(d)(2)(D).

[61] Code Sec. 904(d)(2)(A)(ii).

[62] *See generally* Reg. §1.861-8. In general, with respect to each deduction, the taxpayer must allocate the deduction to the "class of gross income" to which the deduction factually relates. The "class of gross income" may consist of one or more items (or subdivisions of the items) listed in Code Sec. 61. Reg. §1.861-8(a)(3).

[63] Reg. §1.861-9T(a).

[64] This example is borrowed from The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part Two, Relief of International Double Taxation 264–65 (2001).

[65] The example assumes a 35-percent tax rate.

[66] If the taxpayer's foreign income taxes paid (and deemed paid) exceeds the taxpayer's foreign tax credit limitation, the taxpayer may carry such excess foreign taxes forward 10 years or back one year. Code Sec. 904(c).

[67] Code Sec. 864(f).

[68] §551(a), Hiring Incentives to Restore Employment Act of 2010 (P.L. 111-147) (delaying until tax years beginning after December 31, 2020); §15(a), Worker, Homeownership, and Business Assistance Act of 2009 (P.L. 111-92) (delaying until tax years beginning after December 31, 2017); §3093(a), Housing and Economic Recovery Act of 2008 (P.L. 110-289) (delaying until tax years beginning after December 31, 2010).

[69] *Guardian Industries Corp.*, Fed.Cl, 2005-1 ustc ¶50,263, 65 FedCl 50, *aff'd*, CA-FC, 2007-1 ustc ¶50,281, 477 F3d 1368.

[70] United States Reply Brief, *Guardian Industries Corp.*, No. 2006-5058 (Fed. Cir. Feb. 23, 2007).

[71] For a description of other situations in which separation of foreign taxes from foreign income can occur, *see* Robert Holo and SeoJung Park, *Legislative and Regulatory Attempts to End FTC Splitters,* Tax Notes 491

(Oct. 31, 2011) and New York State Bar Association Tax Section, Report on Issues under Section 909 of the Code (Nov. 8, 2010).

[72] REG-124152-06, 71 Fed. Reg. 44,240 (Aug. 6, 2006); *see also* Notice 2007-95, 2007-2 CB 1091 (deferring the effective date of the Proposed Legal Liability Regulations until after final regulations are published in the Federal Register).

[73] *But see* Howard J. Levine and Michael J. Miller, *Anti-Deferral and Anti-Tax Avoidance: Proposed Regulations "Clarifying" the Technical Taxpayer Rule Don't Pass the Giggle Test*, INT'L TAX J., Jan–Feb. 2007.

[74] Proposed Reg. §1.901-2(f)(2)(i).

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

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

[77] U.S. Treasury Department, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (February 2009).

[78] H.R. 4213, 111th Cong.

[79] Education Jobs and Medicaid Funding Act of 2010 (P.L. 111-226), 124 Stat. 2389.

[80] Code Sec. 909(d).

[81] Code Sec. 909(d)(4).

[82] Notice 2010-92, IRB 2010-52, 916.

[83] *See* Office of Management and Budget, Living Within Our Means and Investing in the Future: The President's Plan for Economic Growth and Deficit Reduction (September 2011) ($52.8 million); Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal (JCS-3-2011), p. 633, June 2011 ($53.1 million); Department of the Treasury, General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals 146 (February 2011) ($51.4 million).

[84] H.R. 3970, 110th Cong.

[85] Budget Control Act of 2011 (P.L. 112-25).

[86] *See* The President's Plan for Economic Growth and Deficit Reduction, Legislative Language and Analysis (Sept. 2011). The Administration's 2012 budget proposal had simply stated: "The proposal would require a U.S. taxpayer to determine its deemed paid foreign tax credit on a consolidated basis based on the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit (including lower tier subsidiaries described in Code Sec. 902(b)). The deemed paid foreign tax credit for a tax year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that tax year. The Secretary would be granted authority to issue any Treasury regulations necessary to carry out the purposes of the proposal." U.S. Treasury Department, General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals 40 (February 2011).

[87] According to the legislative language of the proposal, "[t]he term 'aggregate amount of post-1986 foreign income taxes' means, with respect to any domestic corporation which meets the ownership requirements of subsection (a) or (b) of Code Sec. 902 with respect to one or more Code Sec. 902 corporations, the domestic corporation's *pro rata* share of the post-1986 foreign income taxes (as defined in Code Sec. 902(c)(2)) of all such Code Sec. 902 corporations."

[88] The draft legislation defines the term "aggregate amount of post-1986 undistributed earnings" as "with respect to any domestic corporation which meets the ownership requirements of subsection (a) or (b) of Code Sec. 902 with respect to one or more Code Sec. 902 corporations, the domestic corporation's *pro rata* share of the post-1986 undistributed earnings (as defined in Code Sec. 902(c)(1)) of all such Code Sec. 902 corporations." The aggregate amount of post-1986 earnings for the tax year would be determined by translating each Code Sec. 902 corporation's post-1986 undistributed earnings into dollars using the average exchange rate for each year.

[89] Robert H. Dilworth, *Proposed Multilateral FTC Pooling and U.S. Bilateral Tax Treaties*, Tax Notes 1227 (Sept. 21, 2009).

[90] Martin A. Sullivan, *FTC Proposal Puts Brakes on Earnings Coming Home*, TAX NOTES 717 (June 1, 2009).

[91] Notice 98-5, 1998-1 CB 334.

[92] Notice 2004-19, IRB 2004-11, 606; 2004-1 CB 606.

[93] T.D. 9535, IRB 2011-39, 415.

[94] T.D. 9416, IRB 2008-46, 1142.

[95] The 2008 temporary regulations had modified 2007 proposed regulations (72 FR 15081).

[96] The final regulations clarify with respect to the holding company exception that in cases involving more than one U.S. party or more than one counterparty, or both, the requirement that the parties 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 and all counterparties. If there is more than one U.S. party or counterparty, the final regulations do not require each member of the respective groups to share in the investment risk. The exception is applied beginning with the lowest-tier entity before proceeding upward and the opportunity for gain and risk of loss borne by an upper-tier entity that is a counterparty is disregarded to the extent borne indirectly by a U.S. party.

[97] With respect to the second requirement of the SPV condition, that there is a foreign payment attributable to the income of the entity, the final regulations remove an exception under the temporary regulations that a foreign payment does not include a withholding tax imposed on distributions or payments made by an entity to a U.S. party. According to the preamble of the final regulations, Treasury and the IRS will promulgate additional guidance providing that a foreign payment for this purpose includes a withholding tax imposed on a dividend or other similar distribution.

[98] *Pritired 1 LLC, et al.*, No. 4:08-cv-00082-JAJ-TJS, 2011 U.S. Dist. LEXIS 116366 (S.D. Iowa Sept. 30, 2011)

[99] In addition to finding that the transaction did not give rise to a partnership, the court also determined the transaction violated the partnership anti-abuse rule of Reg. §1.701-2.

[100] *Guardian Industries Corp.*, CA-FC, 2007-1 USTC ¶50,281, 477 F3d 1368.

[101] Rebecca Rosenberg, *New Foreign Tax Credit Anti-Splitting Rule*, Tax Notes, at 701 (Nov. 8, 2010).

[102] *See, e.g.,* United States Reply Brief, *Guardian Industries v. United States*, No. 2006-5058 (Fed. Cir. Feb. 23, 2007) ("The policy of reliving double taxation supports the Government's position that taxpayer is not entitled to the claimed tax credit. Taxpayer is not being taxed twice; it is undisputed that the income to which the foreign tax credits at issue relate—the income of GIE's subsidiaries—has never been taxed in the United States. To allow the credit here would facilitate a convenient scheme for avoiding the United States income tax.").

[103] *See, e.g.,* H. Rep. No. (2004) ("The Committee believes that requiring taxpayers to separate income and tax credits into nine separate tax baskets creates some of the most complex tax reporting and compliance issues in the Code. Reducing the number of foreign tax credit baskets to two will greatly simplify the Code and undo much of the complexity created by the Tax Reform Act of 1986. The Committee believes that simplifying these rules will reduce double taxation, make U.S. businesses more competitive, and create jobs in the United States."); Sen. Rep. No. (2004) ("The Committee observes that under present law, a U.S.-based multinational corporate group with a significant portion of its assets overseas must allocate a significant portion of its interest expense to foreign-source income, which reduces the foreign tax credit limitation and thus the credits allowable, even though the interest expense incurred in the United States is not deductible in computing the

actual tax liability under foreign law. The Committee believes that this approach unduly limits such a taxpayer's ability to claim foreign tax credits and leaves it excessively exposed to double taxation of foreign-source income.").

[104] ABA Section of Taxation Task Force, Report of the Task Force on International Tax Reform 671 (2007)

[105] *See* Gauthier Blanluet and Philippe J. Durand, "General Report" *in* INTERNATIONAL FISCAL ASSOCIATION, CAHIERS DE DROIT FISCAL INTERNATIONAL, KEY PRACTICAL ISSUES TO ELIMINATE DOUBLE TAXATION OF BUSINESS INCOME (2011) (stating that exemption systems never involve "pure exemption. Generally the two systems—exemption and tax credit—apply simultaneously and it is this coexistence which creates some complexity").

[106] Ways and Means Discussion Draft (Oct. 26, 2011), available online at *http://waysandmeans.house.gov/UploadedFiles/Discussion_Draft.pdf*.

[107] The discussion draft also proposes to reduce the corporate tax rate to 25 percent and adopt thin capitalization rules. In addition, the draft provides three options to address base erosion.

[108] Technical Explanation of the Ways and Means Discussion Draft Provisions to Establish a Participation Exemption System for the Taxation of Foreign Income 26 (Oct. 26, 2011), available online at *http://waysandmeans.house.gov/UploadedFiles/FINAL_TE_--_Ways_and_Means_Participation_Exemption_Discussion_Draft.pdf*.

[109] *Id.*

[110] Daniel Shaviro, *The Case Against Foreign Tax Credits*, 3 J. LEGAL ANALYSIS 65 (2011); Daniel Shaviro, *Rethinking Foreign Tax Creditability*, 63 NAT'L TAX J. 709 (2010).