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ABSTRACT: Matthew Stevens critiques a recent chief counsel advice dealing with the effect of the noncompulsory payment regulation on a taxpayer's foreign tax credit.

SUMMARY:

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Matthew Stevens critiques a recent chief counsel advice dealing with the effect of the noncompulsory payment regulation on a taxpayer's foreign tax credit.

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IRS Says U.K. Tax Not Compulsory, But Taxpayers Need Not Agree

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In a recent chief counsel advice, the IRS concluded that, under the noncompulsory payment regulation, a taxpayer's otherwise- allowable U.S. foreign tax credit must be reduced to the extent that the taxpayer could have reduced its U.K. corporation tax by increasing its liability for a noncreditable U.K. tax. The author concludes that neither the plain language of the noncompulsory payment regulation nor the underlying policies of the regulation support the result reached by the IRS. Thus, the author concludes that, while not free from doubt, the result reached in the chief counsel advice appears erroneous.

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I. Introduction

The foreign tax credit is hot these days. Treasury and the IRS have recently released the proposed regulations^{1/} issued in response to *Guardian Industries Corp. v. United States*.^{2/} They also released last year guidance under section 901(l), relating to the allowability of foreign withholding taxes imposed on back-to-back royalty payments.^{3/} IRS Commissioner Mark Everson has testified before the Senate Finance Committee regarding his concerns about cross-border tax arbitrage transactions,^{4/} and those transactions are also rumored to be the subject of an upcoming IRS notice or other published guidance. Practitioners have weighed in on those transactions as well.^{5/} The IRS has indicated a desire to refight on the terrain of the Second Circuit the battles it lost in the *Compaq* and *IES* cases in the Fifth and Eighth Circuits, respectively.^{6/} Thus, any thoughts of the IRS regarding the FTC should be of considerable interest to those who practice in this area.

One indication of those thoughts appeared on February 16, 2006, when the IRS issued Chief Counsel Advice 200622044, Doc 2006- 10614, 2006 TNT 107-81 (the CCA). The CCA dealt primarily with the noncompulsory payment regulations appearing at reg. section 1.901-2(e)(5) (the noncompulsory payment regulation or the regulation). In summary, the CCA held that a U.K. controlled foreign corporation could not claim an FTC for U.K. corporation tax to the extent the taxpayer could have reduced the tax, but did not, by non- U.K. withholding taxes imposed on dividends received by the CFC. In light of the paucity of authorities that deal with noncompulsory payments, the issuance of the CCA provides an excellent opportunity to examine the technical and policy issues in this area.

II. The Chief Counsel Advice

The CFC described in the CCA is a wholly owned U.K. subsidiary of a U.S. corporation (the parent). The CFC was engaged in a financial services business. As part of its business, the CFC held long physical positions in stocks and

received dividends with respect to those stocks. The dividends were generally subject to U.K. corporation tax and, in the case of non-U.K. issuers, were subject to non-U.K. withholding tax (the foreign withholding tax). As another part of its business, the CFC borrowed shares of publicly traded stock of both U.K. and non-U.K. issuers and lent those shares to its customers. As is customary in stock borrowing transactions, the CFC was required to pay to the counterparty from whom it had borrowed the stock an amount equal to any dividend paid on that stock. In the United States, those payments are referred to as "substitute dividend payments." In the United Kingdom, substitute dividend payments made with respect to the stock of non-U.K. issuers are referred to as "manufactured overseas dividends," or "MODs," and they were subject to a strange U.K. tax regime. The United Kingdom imposed a withholding tax (regardless of whether the recipient was U.K. or foreign) that was equal to the rate of foreign withholding tax that the issuer's jurisdiction would have imposed on the dividend had the dividend (rather than the substitute payment) been paid to the recipient of the MOD. The United Kingdom did not, however, transmit the tax to the issuer's jurisdiction; rather, it kept the money for itself. That U.K. withholding tax on MODs is referred to in the CCA as the required withholding tax (the RWT)./7/

An example here, which is based on the facts of an example given in the CCA, may help keep the facts straight. Suppose first that, apart from this transaction, the CFC had \$ 500 of income that was subject to tax at a rate of 20 percent. Accordingly, the CFC would have been, absent this transaction, liable for U.K. corporation tax in the amount of \$ 100. Suppose also that the CFC had borrowed a share of stock, the dividend on which would have been subject to French withholding tax at a rate of 10 percent. Finally, assume that the CFC held on the relevant dividend record date a share of a different stock, the dividend on which was subject to German withholding tax at a rate of 10 percent. Each stock then paid a dividend of \$ 100. (For simplicity, this article ignores the fact that European corporations rarely pay U.S. dollar-denominated dividends.) The United Kingdom imposed \$ 10 of RWT on the MOD the CFC paid on the French stock, and Germany imposed \$ 10 of foreign withholding tax on the dividend paid to the CFC on the German stock./8/

If not for the interaction described below among the U.K. corporation tax regime, the foreign withholding tax, and the RWT regime, the U.S. FTC analysis of those transactions would be relatively straightforward. The \$ 100 of U.K. corporation tax imposed on the CFC (before taking into account the effects of the stock lending and stock purchase transactions) would be a creditable tax. The \$ 10 of RWT likely would not be a creditable tax to the CFC, because it is not imposed on the income of the CFC, but rather on the income of the recipient of the MOD./9/ Whether or not the \$ 10 of foreign withholding tax would be creditable would depend in part on whether the CFC had satisfied the 16-day holding period requirement of section 901(k)/10/ regarding the stock on which the dividend was paid. If it did not satisfy that requirement, the foreign withholding tax would be disallowed as a credit, unless, *inter alia*, the foreign withholding tax met the requirements of section 901(k)(4), as discussed below. If the United Kingdom permitted the foreign withholding tax as a credit against CFC's U.K. corporation tax, the foreign withholding tax would have satisfied all of the requirements of section 901(k)(4)/11/ and therefore would have been a creditable tax for purposes of section 901. In those circumstances, the parent would be entitled to a U.S. FTC for \$ 10 of foreign withholding tax and \$ 90 of U.K. corporation tax under section 901 (by way of section 902)./12/

As alluded to above, however, U.K. tax law permitted the CFC to elect to "set off" the \$ 10 in foreign withholding tax against either (1) the RWT imposed on the MOD or (2) the CFC's liability for U.K. corporation tax. If it chose the former, the CFC would be permitted to withhold from the MOD the amount of the RWT, but would not be required to pay that amount over to the U.K. government. Faced with the choice of using the \$ 10 foreign withholding tax to reduce a creditable tax or a noncreditable tax, the CFC chose to credit the \$ 10 foreign withholding tax against its RWT liability rather than its U.K. corporation tax liability. Thus, the CFC wound up paying no RWT (net of the \$ 10 credit) and \$ 100 of U.K. corporation tax. Alternatively, the CFC could have chosen to reduce its liability for U.K. corporation tax by the \$ 10 in foreign withholding tax, leaving its liability for RWT at \$ 10 and its liability for U.K. corporation tax at \$ 90. In each case, of course, the CFC's total liability for U.K. tax (including corporation and RWT tax) would have been the same, \$ 100. The parent claimed under section 902 or section 960 FTCs for the amount (\$ 100) of the CFC's net corporation tax liability to the United Kingdom. The parent also claimed the FTC for the \$ 10 in foreign withholding tax suffered by the CFC on the dividends it had received from non-U.K. issuers.

The IRS disallowed the claimed U.S. FTC of the parent relating to \$ 10 of the CFC's liability for U.K. corporation tax. It based that conclusion on the noncompulsory payment regulation. That regulation first states the general rule that "[a]n amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax." The regulation then goes on to provide that:

An 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, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax adjustment).^{13/}

The IRS, applying the first part of the quoted language, concluded with no reasoning that the parent had not shown that it had "reduced . . . over time" its liability for U.K. corporation taxes, and that the U.K. corporation tax payment of \$ 100 was therefore noncompulsory to the extent of the amount of the foreign withholding tax that was used to reduce the RWT (\$ 10). The IRS also concluded that the \$ 10 in foreign withholding tax was not itself creditable under section 901 because the U.K. government did not allow a credit against the CFC's U.K. corporation tax liability for the foreign withholding tax (because the U.K. government had instead allowed a \$ 10 credit against the CFC's RWT liability). Thus, by choosing to use the \$ 10 of foreign withholding tax to reduce its RWT liability rather than its U.K. corporation tax liability, the parent was held to have lost both \$ 10 in credit for its foreign withholding tax and an additional \$ 10 of credit for its U.K. corporation tax liability. The question to be addressed in the remainder of this article is whether the latter forfeiture was required under the regulation.

III. Analysis

A. The Scope of the Regulation

A careful consideration of the policy concerns in this area leads to the conclusion that the IRS likely erred in disallowing the FTC for that portion of the CFC's U.K. corporation tax (that is, \$ 10) that could have been offset by the foreign withholding tax had that foreign withholding tax not been used to reduce the CFC's liability for RWT. As a technical matter, the critical ". . . in such a way as to reduce, over time, . . ." language of the noncompulsory payment regulation is so general as to be virtually meaningless. Moreover, the cases and published rulings that deal with this area address factual situations that are quite different from that presented here.^{14/} Therefore, it makes sense to begin the analysis of the strength of the IRS's conclusions by looking to the fundamental policy concerns that motivated the noncompulsory payment regulation.

1. The problem of moral hazard. A fair reading of the noncompulsory payment regulation, taken as a whole, strongly suggests that it is concerned primarily with moral hazard.^{15/} Clearly, if a taxpayer makes a payment to a foreign government, but does not actually have legal liability for that tax under the foreign income tax laws, no U.S. FTC should be allowed for that amount. The noncompulsory payment regulation takes that as a starting point. But foreign tax laws can be unclear (a phenomenon also not unknown to U.S. tax practitioners), and it will not always be evident to either the taxpayer or the IRS whether an item of asserted foreign income tax liability is actually due.^{16/} In those circumstances, the taxpayer's economic incentives to contest the foreign tax liability may be heavily influenced by the potential for a U.S. FTC.

Suppose a foreign taxing authority asserts that a particular taxpayer owes a foreign income tax of Euro 100,000. The taxpayer believes that if it challenges the tax through the appropriate foreign administrative and judicial processes, it would have an 80 percent chance of prevailing. However, the cost of that process will be approximately Euro 10,000. A rational taxpayer who could not benefit from the U.S. FTC would almost certainly decide to challenge the imposition of the tax because, by doing so, it will have an 80 percent chance of avoiding an otherwise certain Euro 100,000 payment, in return for a known cost of Euro 10,000. Phrased more precisely, the decision to challenge the foreign taxing authority will have a negative expected value of Euro 30,000 (that is, a 20 percent chance of losing Euro 100,000 plus an 80 percent chance of losing zero plus, in each case, a known cost of Euro 10,000). If the taxpayer does not challenge the foreign taxing authority's assertion of tax, it would have a negative expected value of Euro 100,000 (that is, it simply pays the tax and goes home). Thus, if not for the FTC, a rational taxpayer would be expected to challenge the foreign taxing jurisdiction.

For a taxpayer that can benefit from the U.S. FTC, however, the calculations work out differently.^{17/} If that taxpayer pays the foreign income tax, it will have an expected cost of zero because it avoids the transaction costs and the net after-U.S. FTC tax cost of paying the foreign tax is zero. However, if the taxpayer decides to challenge the foreign taxing jurisdiction on the merits, it will incur a cost of at least Euro 10,000. In that example, unlike the one in the preceding paragraph, the taxpayer would be irrational to challenge the imposition of the foreign income tax^{18/} (absent the noncompulsory payment regulation). In addition to obtaining a higher expected value, by paying the tax the taxpayer would also avoid the possible assertion of penalties under foreign law, and would be able to conduct its U.S. FTC planning with more certainty.^{19/}

In the absence of a rule dealing with noncompulsory payments, Treasury might reasonably fear, in this situation, that it would be easier for a taxpayer simply to pay a creditable foreign tax than to avoid it, if by paying the tax the taxpayer could avoid incurring some other type of cost (for example, the expenses of a proceeding before a foreign taxing tribunal) or could secure some other benefit. That moral hazard is objectionable from a tax policy perspective for at least three reasons (aside from revenue-related concerns). First, any payments the U.S. taxpayer makes in excess of its actual liability under foreign tax law essentially constitute a subsidy to the foreign government from the U.S. government. Second, in those situations, it is likely that the U.S. taxpayer is being taxed more heavily than comparable local businesses in the foreign country, and the result is thus discriminatory as between U.S. taxpayers and comparable foreign taxpayers. Third, the allowance of the U.S. FTC in this situation would distort the taxpayer's behavior in a manner not contemplated by Congress in enacting the U.S. FTC. That is, the allowance of an FTC was generally intended to remove the sting of paying foreign taxes on income that was generally subject to U.S. tax, not to encourage a taxpayer to pay foreign tax rather than pay a lesser amount of noncreditable expenses, as in the example above.

The parent could argue persuasively that its fact pattern was quite different than the fact pattern described in the preceding paragraphs and does not raise the specter of moral hazard. There is clearly no subsidy with respect to the U.K. corporation tax imposed on the CFC because the U.K. government is not receiving any amount in excess of the amount clearly required by its own taxing statutes. Moreover, the U.S. taxpayer is not being taxed any more heavily by the United Kingdom than a comparably situated U.K. taxpayer. Finally, in the CCA, allowing the FTC for the disputed \$ 10 of U.K. corporation tax would not distort the taxpayer's behavior in similar situations. In the CCA, if the U.S. FTC did not exist, the parent would presumably be indifferent whether it credited its foreign withholding tax against its RWT or against its U.K. corporation tax liability. The allowance of the U.S. FTC in this situation, then, would at most constitute a mere feather on a set of scales otherwise in equipoise. Concerns about moral hazard, then, do not appear to justify requiring the parent to make the choice that benefits the U.S. fisc at the expense of the parent's shareholders.

2. The limits of the noncompulsory payment regulation. If the moral hazard issues described above may be thought of as the core concern of the noncompulsory payment rule, what marks the outer boundaries of the rule? All foreign taxes are noncompulsory in the broad sense that some voluntary action nearly always must be undertaken by the taxpayer in the foreign country (for example, building a factory, opening a mine, and so forth) before foreign tax liability will accrue. Because Congress, in enacting the FTC, intended it to apply to prevent double taxation of the same income by the United States and a foreign country, and because double taxation would frequently result from a broadly

defined noncompulsory payment rule, to adopt such a rule would run contrary to the intent of Congress. Instead, one would expect the noncompulsory payment regulation not to be applied to the action of a taxpayer that is proximately connected to the taxpayer's business activities (broadly defined) merely because that action also subjects the taxpayer to more foreign tax than the taxpayer would otherwise pay. Instead, the noncompulsory payment regulation should generally be confined to the taxpayer's administrative actions with respect to the taxing authorities.

The noncompulsory payment regulation, as drafted, embodies the distinction between the conduct of business on one hand, and the tax administrative process on the other. The last sentence of the text of the regulation provides that there is "[no] requirement that taxpayer 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."²⁰ That broad language does not require that the taxpayer demonstrate that the form of a transaction or of doing business is chosen for a substantial business purpose, or indeed for any particular purpose at all. Rather, the noncompulsory payment regulation may affect only the foreign tax administrative process, including the filing of a return, the making of elections, and the contest of foreign tax issues, including through competent authority.

The IRS could rightly point out, however, that the outcome described in the CCA does not require a taxpayer to alter its form of doing business, its business conduct, or the form of any business transaction. Rather, the IRS would require the taxpayer in effect to make a different election on its U.K. tax return, which is within the outer boundaries of the concern addressed by the noncompulsory payment regulation. Having delineated both the core concerns and the outer boundaries of the noncompulsory payment rule, and finding the facts of the CCA not to fall within the core concern, nor beyond the outer boundaries, it remains to delve more deeply into that regulation to see whether the result reached in the CCA is consistent with the intent of the drafters. As noted above, this article concludes that such consistency is lacking.

B. Interpreting the Regulation

1. Concerns about authority. Before examining specific provisions of the noncompulsory payment regulation, it is worth noting Treasury's limited authority in this area. There is no legislative authority for Treasury to issue regulations under section 901 dealing with noncompulsory payments. Therefore, the regulation is interpretative in character. When foreign law is unclear whether a tax really is due, it seems reasonable and well within Treasury's authority to write interpretive regulations to require taxpayers to show that a reasonable taxpayer actually would (or might) have paid the foreign tax under the relevant circumstances even if it had not been creditable. In the CCA, however, U.K. law is clear that once the CFC had elected to credit its foreign withholding tax against its RWT rather than its U.K. corporation tax, the amount of U.K. corporation tax that was due was \$ 100, not \$ 90. When a taxpayer is legally liable for the tax, and it was rational for it to pay that tax rather than dispute it, it is questionable whether Treasury has the authority to write a rule that says the tax is treated as noncompulsory merely because the parent could have avoided it by paying some other tax in the same amount. And, a fortiori, if it would be questionable for Treasury to have written a regulation that said that explicitly, it is even more dubious to interpret the existing ambiguous rule as requiring that result.

2. Effective and practical remedies. Earlier, this article concluded that the core concern of the regulation was the moral hazard attendant on foreign tax controversies. Even in this area, however, the regulation treads lightly. Thus, the noncompulsory payment regulation requires the taxpayers to "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 adjustment)."²¹ One of the examples in the regulation reinforces that point, demonstrating how a taxpayer who loses an issue in an administrative proceeding in the foreign country need not continue to contest the foreign tax liability to claim a credit under section 901. The example explains that "[t]he cost of pursuing any judicial remedy in country X would be unreasonable in light of the amount at issue and the likelihood of B's success, and B does not pursue any such remedy."²² Nevertheless, the example concludes, the entire amount paid by B is a compulsory payment.

The requirement that a taxpayer is required only to pursue those remedies that are "effective and practical" provides

a telling analogy to the facts of the CCA. Presumably, the IRS would not consider a remedy effective and practical if the cost of pursuing the remedy equals the amount of the foreign tax that would be saved if the remedy were successful. For example, if the disputed amount of foreign tax equaled Euro 100, and the cost of the administrative action also equals Euro 100, the regulation would presumably be interpreted not to require the taxpayer to pursue the administrative action even if the likelihood of success is 100 percent, because the taxpayer would gain nothing from that pursuit. Yet the IRS, in the CCA, is essentially putting the parent in an analogous position. It concludes that the parent should give up Euro 100 in credits against its RWT liability to reduce its U.K. corporation tax liability by an equal amount. Because a taxpayer, acting without regard to the availability of the U.S. FTC, would have no incentive to take that action, the conclusion in the CCA that the parent was required to use its foreign withholding tax liability to reduce its U.K. corporation tax appears dubious.

3. The acceptance of tax planning. The noncompulsory payment regulation generally takes a tolerant attitude toward foreign tax planning by U.S. taxpayers. That tolerance is reflected both by the relaxed attitude to the taxpayer's choice of form and by the rule permitting a taxpayer to accelerate its foreign tax liability, each as discussed below.

The regulation does not require that foreign tax liability be minimized from a present value perspective. That is illustrated by the requirement that the taxpayer's required minimization of his liability for foreign tax occur "over time." That somewhat cryptic statement is more fully explained in Example 5 in the regulation, in which the taxpayer elects to depreciate some machinery over the longest permissible period allowed by foreign law.²³ The example concludes that the taxpayer has complied with the regulation's command to reduce over time his reasonably expected liability for foreign tax. Thus, just as a taxpayer need not pursue every possible administrative avenue to minimize his tax liability, so, too, the taxpayer need not pursue every possible planning angle to defer his foreign tax liability.²⁴

The "hands-off" attitude that the regulation takes toward the taxpayer's choice of form also facilitates foreign tax planning. As noted above, taxpayers not only need not alter their business conduct to stay out of the noncompulsory payment rules, they also need not alter the form of any transaction or the form of their business conduct. Thus, the taxpayer is apparently permitted to choose the form of its transaction without showing that such form had any nontax benefit, or even any nontax consequences, and the IRS is still not permitted to use the noncompulsory payment regulation to conclude that the tax payable to the foreign government solely by reason of that form is noncreditable. Implicit in that rule is the notion that a taxpayer can choose its form to subject itself to more, or different, foreign tax liability than it otherwise would have. Suppose that U.K. tax law had provided that if the parent had chosen to conduct its business through a limited liability company instead of a corporation, the foreign withholding tax would have been creditable only against the U.K. corporation tax liability, but that if the parent had instead conducted its business through a corporation, the foreign withholding tax would have been creditable only against its RWT liability. If, under such a law, the parent had chosen to conduct its business through a corporation rather than an LLC, the U.K. corporation tax clearly would have been creditable, regardless of whether that choice of form had had any real-world (that is, nontax) significance for the parent's business. There does not appear to be any policy rationale for a different answer merely because, under the facts of the actual CCA, the CFC's liability for U.K. corporation tax is determined based on how it fills out its U.K. tax returns rather than by the type of entity through which it chooses to conduct its business.

(It is interesting, albeit somewhat discursive, to inquire about the causes of this tolerance for foreign tax planning. Likely, a variety of factors are responsible. First, foreign income tax laws are diverse and complex. Taxpayers, especially the large U.S. multinational corporations that tend to incur the vast majority of creditable foreign taxes, engage in complicated transactions. The IRS has no particular expertise in interpreting foreign tax law and can obtain the expertise necessary to do so only at considerable expense.²⁵ That argues in favor of not requiring taxpayers to prove to a high degree of certainty that they have minimized their foreign taxes. Second, a more aggressive approach to policing the taxpayer's choice of form would run contrary to the fundamental purpose of the FTC, under which the United States defers to the foreign country by giving the foreign tax precedence over the U.S. tax liability. A more aggressive approach would also ensnare the IRS and taxpayers in an endless debate over whether a particular choice of form was appropriate. Third, the U.S. government must concern itself not only with the taxpayer, but also with its

relationship with the foreign taxing jurisdiction. To the extent the regulation is interpreted as requiring taxpayers to minimize their foreign tax liability, it is requiring taxpayers to take positions under foreign tax law that could be seen as overly aggressive, or perhaps simply incorrect under that law. That would put the IRS in the awkward position of encouraging foreign tax avoidance and facing potential complaints from foreign governments. It is even conceivable that those foreign countries that allow U.S. income taxes as FTCs against their own income taxes could retaliate against the United States.)

Regardless of why the regulation takes a lenient position on foreign tax planning, that it does so is difficult to square with the IRS's position in the CCA. On one hand, the taxpayer is explicitly permitted to accelerate its foreign tax liability solely by using an administrative procedure (that is, without changing the form of any transaction). On the other hand, the taxpayer is implicitly, but clearly, permitted to incur additional foreign income taxes by choosing the form of that transaction, even when the form may accomplish nothing except to subject the taxpayer to additional foreign tax. Given those two factors, and recalling that the transaction does not present the core concern of moral hazard, it is difficult to see any rationale for requiring the CFC in the CCA to reduce its liability for U.K. corporation tax by crediting the foreign withholding tax against such creditable U.K. corporation tax rather than against the RWT.

4. The effect of the form of the foreign law. The parent's position that the full amount of the CFC's U.K. tax liability is creditable finds support in regulations issued under section 901 (the multiple levy regulations). Those regulations apply when (1) the taxpayer is subject to both a creditable tax and a noncreditable tax and (2) the computation of the amount due under one tax can be affected by the amount of tax due under the other tax.²⁶ Largely for reasons of administrative convenience, the multiple levy regulations essentially look to the form taken by the foreign tax law, providing in effect that the taxpayer is considered for U.S. purposes to have paid whichever tax (creditable or noncreditable) that it is considered to have paid under foreign law.²⁷ Thus, suppose that, instead of giving the CFC an election to have reduced either its U.K. corporation tax or its RWT, the United Kingdom had required that the foreign withholding tax first be credited against the RWT, and only to the extent of any excess, against the parent's liability for U.K. corporation tax. Then the parent would have had no election to have reduced its U.K. corporation tax liability instead of its RWT tax liability, and the IRS would have been compelled to conclude under the multiple levy regulations that all of the U.K. corporation tax payments the CFC made were compulsory. While the U.K. tax rule allowing the offset of the foreign withholding tax against the RWT was voluntary rather than mandatory, the formality inherent in the multiple levy regulations nonetheless argues in favor of the parent's position in the CCA. Absent any concern about moral hazard here, no policy-based distinction exists for making the U.S. creditability of the U.K. corporation tax depend on whether the United Kingdom required the use of the foreign withholding tax first against the RWT, and then against the U.K. corporation tax liability, or merely gave the taxpayer the right to choose that result.

C. What Was Really Going On Here?

This article has shown that the IRS's conclusion was not required from a technical perspective and was a considerable stretch from a policy standpoint. Moreover, from the standpoint of equity, the IRS's conclusion seems somewhat harsh. The CFC had, apart from this transaction, \$ 500 of income that is subject to tax at a rate of 20 percent and, accordingly, the CFC would have been liable for U.K. corporation tax in the amount of \$ 100, absent this transaction. Recall also that the CFC paid a MOD of \$ 100, subject to RWT at a rate of 10 percent, for a RWT tax (before offset) of \$ 10. Recall finally that the CFC received a \$ 100 dividend subject to foreign withholding tax at a rate of 10 percent, or \$ 10. The CFC elected under U.K. law to reduce the amount of its RWT by the full amount of that foreign withholding tax, or \$ 10. From a pure economic perspective, the CFC is flat, having taken in an additional \$ 90 (the \$ 100 dividend less the \$ 10 of foreign withholding tax) and paid out \$ 90 (the \$ 90 in MOD, less the \$ 10 RWT, plus the \$ 10 credit against the RWT allowed for the foreign withholding tax). Once it is concluded that the \$ 10 of foreign withholding tax is not creditable under section 901(k), the CFC has also neither increased nor decreased the amount of foreign taxes the parent can claim as credits. Because of the parent's decision to use \$ 10 of foreign withholding tax to reduce a noncreditable tax (the CFC's RWT) instead of a creditable one (the CFC's U.K. corporation tax), the IRS concluded that the parent must forfeit the U.S. FTC attributable both to the \$ 10 of foreign withholding tax

(because the requirements of section 901(k)(4) were not satisfied) and to the \$ 10 of the U.K. corporation tax (under the noncompulsory payment regulations). Why did the IRS adopt that position in the absence of any persuasive technical or policy reason to do so? What was really going on here?

One suspects the IRS was concerned about a hypothetical situation that would be similar to that described in the CCA, except that the CFC would have held its long position in stock for more than the requisite 15 days, thus preventing the application of section 901(k). In that case, as a result of the transaction, the taxpayer would have been entitled to \$ 10 of U.S. FTC for the foreign withholding tax paid plus all of the U.S. FTC for the U.K. corporation tax that it would have paid without regard to this transaction. From a pure policy perspective, that result is inappropriately generous because the CFC was not actually out any money as a result of the foreign withholding tax. That is, by first imposing RWT and requiring the CFC to withhold the \$ 10, and then allowing the CFC to keep the \$ 10 under the "setoff" mechanism, the U.K. had in effect reimbursed the CFC for the foreign withholding tax. It would therefore be inappropriate from a macro policy perspective for the parent to be allowed a U.S. FTC for the amount of the foreign withholding tax. If, however, the parent could properly be forced under the regulation to use the \$ 10 of foreign withholding tax to reduce the CFC's U.K. corporation tax rather than its RWT, the correct answer would result. The parent would then be allowed a section 901 credit for the \$ 10 of foreign withholding tax (because the requirements of section 901(k)(4) would have been satisfied) and would have had to reduce its section 901 credit for its U.K. corporation tax by \$ 10 (because its liability for that tax actually would have gone down by that amount). The total payments of the CFC's creditable foreign tax would thus have remained unchanged at \$ 100, as would the CFC's net post-foreign-tax cash flows (because the CFC receives a \$ 90 dividend net of foreign withholding tax, pays out \$ 90 in an after-RWT MOD, pays \$ 10 of RWT, and receives a \$ 10 reduction in its U.K. corporation tax).

However, even though application of the regulation may have indirectly forced a taxpayer to reduce its U.S. FTC to the appropriate amount, the application of the regulation still appears unjustified. Under the technical taxpayer rule, a taxpayer is not required to bear the economic burden of the foreign tax to be allowed a foreign tax credit for that tax. And the fact that the CFC did not bear the economic burden of the foreign withholding tax does not create a moral hazard as defined above, regardless of whether section 901(k) applies. Moreover, the remaining analysis set forth above in Part II.B.2 applies with equal force whether or not section 901(k) applies. Thus, while one sympathizes with the IRS's concerns in the case described in the previous paragraph, that sympathy does not by itself support the application of the noncompulsory payment regulation.

Because of that lack of justification, the IRS's position under the regulation seems difficult to justify, even under the more sympathetic case in which section 901(k) does not apply. It is worth considering whether there were theories other than the noncompulsory payment regulation that the IRS could have used to attack the transaction it appears to have been worried about. For example, could the IRS have considered whether it could treat the foreign withholding tax as not having been incurred by reason of its being refunded or credited? Reg. section 1.901-2(e)(2)(i) provides that "[a]n amount is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven." However, because it was Germany that withheld the foreign withholding tax and the United Kingdom that allowed the credit against the RWT, and because there is no indication that Germany paid the withheld amounts to the United Kingdom, it would be difficult if not impossible under common law tax principles to treat the U.K. credit against the RWT as a "refund" of the foreign withholding tax. A similar concern would have befallen any attempt to use the subsidy rules in reg. section 1.901-2(e)(3) because those rules, too, apply only when the government that provides the putative subsidy is also the government that imposes the tax with respect to which that putative subsidy is paid.

IV. Conclusion

The CCA appears ultimately to be based on a broad-based concern about any election made in the creditable foreign tax context that works against the interests of the U.S. fisc.²⁸ By contrast, the regulation was intended primarily to get at situations in which taxpayers are engaging in activities that raise the specter of moral hazard; the CFC's actions as described in the CCA do not raise that concern. At the same time, the CFC's actions are not within the

scope of the broad carveout relating to additional taxes imposed by reason of the form of the taxpayer's transaction. However, the results reached in the CCA may be beyond the scope of Treasury's authority to interpret the code, and they seem inconsistent with the lenient approach to foreign tax planning that is implicitly adopted by the regulation. Finally, the result reached in the CCA appears to conflict with the policy underlying the multiple levy regulations, without serving any opposing policy goal. On balance, then, it appears that, while not free from doubt, the IRS reached the wrong answer when it ruled that \$ 10 of the CFC's U.K. corporation tax must be disallowed because the \$ 10 in foreign withholding tax could have been used to reduce the CFC's U.K. income tax rather than RWT.

One would have somewhat more sympathy for the conclusion reached by the IRS if the CFC had met the holding period requirements of section 901(k) regarding the foreign withholding tax. But the allowance of the \$ 10 of U.S. FTC in that setting, while inappropriate as a macro policy matter, does not clearly cause the noncompulsory payment regulation to apply technically, nor does it implicate any of the U.S. tax policies underlying the noncompulsory payment regulation. Rather, the objectionable result arises because neither the subsidy rules nor the refund rules apply when one government (here, Germany) imposes a tax, and a second government (here, the United Kingdom) effectively rebates it to the taxpayer. Changing that result should not be done through a misapplication of the noncompulsory payment regulation, but should be done, if at all, by amending the regulations relating to refunds or subsidies.

FOOTNOTES

/1/ Prop. reg. section 1.901-2(f), 71 Fed. Reg. 44240 (Aug. 4, 2006).

/2/ 65 Fed. Cl. 50, Doc 2005-6900, 2005 TNT 64-15 (2005).

/3/ Notice 2005-90, 2005-51 IRB 1163, Doc 2005-24196, 2005 TNT 230-4.

/4/ A Tune-Up on Corporate Tax Issues: What's Going on Under the Hood?: Hearing Before the S. Comm. on Finance, 109th Cong. (2006) (statement of The Honorable Mark Everson, Commissioner, Internal Revenue Service).

/5/ Letter to Treasury and the IRS from Steptoe & Johnson LLP, Doc 2006-14510, 2006 TNT 148-28 (Aug. 2, 2006).

/6/ IRS memorandum, Doc 2006-9762, 2006 TNT 98-20 (May 23, 2006).

/7/ The recipient of the MOD was then allowed a credit against its own tax liability for the amount of the RWT withheld.

/8/ This example differs from the facts of the CCA in one respect. In the CCA, the foreign withholding tax actually exceeded the RWT, and the remainder was used to reduce the U.K. corporation tax of the CFC. The parent conceded, as it certainly should have, that to the extent the U.K. corporation tax actually was reduced by the foreign withholding tax, no FTC was allowable. To simplify the math, this article uses numbers in which the RWT equaled the foreign withholding tax. That simplification does not affect the legal analysis.

/9/ See *Wisconsin Gas & Electric Co. v. United States*, 322 U.S. 526 (1944) (when Wisconsin imposed tax on payment of dividend by corporation to shareholder, and required corporation to withhold that tax from payment of dividend, corporation was not allowed federal income tax deduction for withheld tax).

/10/ Section 901(k)(1) generally disallows an FTC for any withholding tax on a dividend with respect to stock in a corporation if that stock is held by the recipient of the dividend for 15 days or less during the 31-day period beginning on the date that is 15 days before the date on which the stock becomes ex-dividend with respect to the dividend.

/11/ Section 901(k)(4) provides an exception from the general 16-day holding period requirement of section 901(k) for a "qualified tax" with respect to any security held in the active conduct in a foreign country (the home country) of a

business as a securities dealer of any person who, in general, is regulated as a securities dealer. A "qualified tax" means a tax paid to a foreign country other than the home country (the source country) if the dividend to which the tax is attributable is subject to tax by the home country on a net basis and if the home country allows a credit against its net basis tax for the full amount of the withholding tax paid to the source country.

/12/ The \$ 90 amount is based on the assumption that the United Kingdom would require the inclusion of the \$ 100 German dividend in income, but then allow a deduction against the U.K. corporation tax for the \$ 100 MOD paid by the CFC.

/13/ Reg. section 1.901-2(e)(5)(i).

/14/ See *Riggs National Corp. v. Commissioner*, 107 T.C. 301, Doc 96-31895, 96 TNT 240-2 (1996) (when taxpayer was not legally liable for Brazilian tax, purported payments of tax were noncompulsory payments within the meaning of reg. section 1.901-2(e)(5)). See also Rev. Rul. 92-75, 1992-2 C.B. 197 (when the IRS allocated income from foreign subsidiary to domestic parent, and parent did not request assistance from U.S. competent authority to coordinate amount of tax due the foreign country, the foreign income taxes imposed on the income of subsidiary would be treated as noncompulsory payments).

/15/ In law and economics, moral hazard is the name given to the increased risk of problematical (immoral) behavior, and thus a negative outcome (hazard), because the person who caused the problem doesn't suffer the full (or any) consequences, or may actually benefit. http://en.wikipedia.org/wiki/Moral_hazard.

/16/ Indeed, if the regulation were concerned only about situations in which liability was clearly lacking, the drafters need not have issued a separate rule dealing with noncompulsory payments; the technical taxpayer rule of reg. section 1.901-2(f) would have disallowed the credit if the taxpayer lacked liability for the tax. See *Riggs*, supra note 14.

/17/ The analysis in this paragraph assumes that the taxpayer has an unlimited amount of foreign source income that it can use to absorb foreign tax. That is an important assumption, and one that is rarely true in practice. The fact that many taxpayers are constrained (or act as though they are constrained) from absorbing additional FTCs tends to support from a policy perspective a narrower reading of the noncompulsory payment regulation.

/18/ In describing the situation as one of moral hazard, this article implicitly assumes that the taxpayer cannot benefit by more than \$ 1 for each dollar's worth of foreign tax he pays. Thus, the article deliberately ignores the case of the cross-border arbitrage transaction, in which the taxpayer or its CFC pays FTC that it can use in his own country and that a transactional counterparty can use in its own country. In those transactions, a portion of the benefit of the counterparty's use of the foreign tax paid is passed along to the taxpayer through advantageous rates on funding or investment. In effect, then, each dollar of foreign tax paid produces more than \$ 1 of after-tax benefits to all parties, taken together. Those transactions present their own issues, which, to use the favorite phrase of daunted authors everywhere, are beyond the scope of this article.

/19/ This last point would have been of particular concern before the Tax Reform Act of 1986 eliminated the concept of "layers" of earnings and profits, each with an associated layer of tax. Under that approach, having foreign tax incurred in a year in which the taxpayer had no E&P in its CFC for U.S. income tax purposes could prevent the tax from ever being allowed as a credit.

/20/ It is this sentence, so comprehensive in scope and definitive in tone, that prevents the IRS from using the noncompulsory payment regulation to challenge the intended results of the FTC arbitrage transactions described in note 18 supra. That having been said, it is not clear how the IRS would change the language to permit an assertion that a particular cross-border transaction violated this rule. In the final analysis, as noted in the text, all liability for foreign income taxes is the result of voluntary conduct to some degree (for example, building a factory in a foreign country), and it is not clear what test the IRS and Treasury might devise that would divide the foreign tax paying community in the appropriate way. But see *Steptoe & Johnson* letter, supra note 5.

/21/ In CCA 200532044 (May 5, 2005), Doc 2005-17164, 2005 TNT 156-9, the IRS concluded that because the taxpayer had not pursued competent authority relief under the relevant tax treaty, the taxpayer's Country X income tax payments were noncompulsory and therefore not creditable. Interestingly, while the document was heavily redacted, it appears that the only grounds the IRS had for concluding that the taxpayer was reasonably likely to have received competent authority relief from Country X taxation was the taxpayer's own statement to Country X tax authorities that it would not pursue that relief.

/22/ Reg. section 1.901-2(e)(5)(ii) (Ex. 3).

/23/ Reg. section 1.901-2(e)(5)(ii) (Example 5).

/24/ It is unclear why the regulation adopts an explicit rule for timing differences under foreign tax law while remaining silent on permanent differences. The difference may reflect sympathy for taxpayers trying to align their foreign and U.S. tax liabilities under pre-Tax Reform Act of 1986 law, which, as noted above in note 19, placed a premium on getting one's foreign tax liability in the right layer of E&P. Or it may reflect the view of an earlier era, in which timing differences generally received less attention from tax policymakers.

/25/ In other areas of international taxation, the regulations are drafted to avoid having the IRS delve into the mysteries of foreign law. Preamble to prop. reg. section 1.901-2(f) ("this approach [i.e., defining combined income to include cases when the applicable consolidated tax regime treats subsidiaries as branches of the common parent] will minimize the need for extensive analysis of the intricacies of the relevant foreign consolidated tax regime"). See also reg. section 1.1503-2(c)(15)(ii), in which a loss, expense, or deduction taken into account in computing a dual consolidated loss (DCL) generally is deemed to offset income of another person under the income tax laws of a foreign country in the year it is made available for offset without any inquiry under foreign law whether the item is actually used. See also prop. reg. section 1.1503(d)-1(b)(14)(ii) ("foreign use shall be deemed to occur in the year in which any portion of a loss or deduction taken into account in computing the [DCL] is made available for an offset" regardless of whether any offset or reduction of foreign tax occurs).

/26/ For example, an amount of liability for the nonincome tax may be creditable under foreign law against the taxpayer's income tax liability. Conversely, an amount of liability for the income tax may be creditable under foreign law against taxpayer's nonincome tax liability. As a third possibility, the taxpayer could simply be required to compute his tentative liability for both taxes, but only to pay whichever has the higher liability. For U.S. tax purposes, it obviously matters greatly whether the taxpayer is viewed as having paid the income tax (which would generally be creditable) or the nonincome tax (which would not be creditable).

/27/ See reg. section 1.901-2(e)(4)(i).

/28/ Applying this concern in other contexts, the IRS may object to the use of the group relief system in the United Kingdom in some contexts. Suppose a CFC has U.K. tax losses that it cannot use, and chooses to surrender them to a U.K. group member who is not scheduled to make any distributions to the U.S. parent. If the loss could instead have been surrendered to a U.K. group member who is scheduled to make distributions to the parent, would the IRS argue that the foreign tax pool of the distributing CFC must be reduced by the U.K. tax benefit of the surrendered loss? If the IRS did make that argument, because the loss may ultimately reduce the group's creditable U.K. corporation tax in any case (that is, if and when the deferred distributions are finally made), however, the taxpayer may be able to argue successfully that this situation would fall within the "over time" rule in the regulation.

END OF FOOTNOTES

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