ALSTON + BIRD LLP

International Tax Advisory

APRIL 15, 2007

Insights Into Recent Regulatory, Judicial and Legislative Developments

Atlanta

Charlotte

New York

Research Triangle

Washington, DC

Proposed Regulations Deny Foreign Tax Credit in Structured Passive Investments

Prop. Reg. § 1.901-2(e)(5) (March 30, 2007)

Overview

Proposed regulation § 1.901-2(e)(5) denies the foreign tax credit for foreign income taxes incurred in connection with certain structured passive investment arrangements. The underlying principle is that a U.S. taxpayer cannot claim a foreign tax credit for foreign income tax that is paid voluntarily.

Background

Under section 901, U.S. taxpayers may, subject to the foreign tax credit limitation regime, claim a credit against U.S. income tax for foreign income taxes paid or accrued during the taxable year to any foreign country (or any U.S. possession). To be creditable, a foreign tax must be a compulsory payment and its nature must be that of an income tax (determined under U.S. principles). A payment is not considered compulsory to the extent it exceeds the taxpayer's liability under foreign law. Under long standing regulations, the taxpayer is required to determine its foreign income tax based on reasonable interpretations and application of substantive and procedural provisions of foreign law. In this connection, the taxpayer's reasonable use of options or elections under foreign law to shift income to future years will not result in a noncompulsory payment. Finally, the regulations specify generally that a taxpayer is not required to alter its form of doing business or any transaction in order to reduce its foreign income tax.

International Tax Arbitrage Transactions

The proposed regulations focus on highly complex international tax arbitrage transactions ("structured passive investment arrangements") that allow U.S. participants to attain foreign tax credits by arguably intentionally paying foreign income tax. In the overall context of the transaction, taxes are reduced, financing is obtained at lower cost than would be the case in a more straightforward structure, and/or fees are earned by participants. The following three broad classes of transactions are identified in the proposed regulations: (i) U.S. borrower transactions, (ii) U.S. lender transactions, and (iii) asset holding transactions.

In a "U.S. borrower transaction", a U.S. person, instead of simply borrowing money, participates in a complex structure to, in effect, convert interest and principal payments into payments of creditable foreign income tax. The foreign tax credit benefit derived by the U.S. person is reflected in the pricing of the arrangement. As a simple example from the proposed regulations, a U.S. person ("USP") is seeking to borrow $1.5 billion from a foreign person, but instead of simply borrowing the money, USP contributes $1.5 billion to a special purpose entity ("SPV") in exchange for 100 percent of the SPV's equity. SPV then loans $1.5 billion to a wholly owned subsidiary of USP. USP "sells" all its SPV stock to foreign counterparty for $1.5 billion, but it is obligated to repurchase the shares in five years and is required to pay interest to the foreign counterparty. This is a repo transaction and for U.S. income tax purposes, USP is considered the owner of the SPV shares because the repo is treated as a secured loan. For foreign income tax purposes, however, the foreign counterparty is treated as the owner of the SPV shares.

Each year SPV earns $120 million of interest from USP's subsidiary, pays $36 million of foreign income tax on that interest and distributes the remaining $84 million to USP, which in turn transfers the $84 million to the foreign counterparty pursuant to the repo transaction. For U.S. income tax purposes, USP recognizes a dividend on the distribution from SPV because it is treated as the owner of the SPV shares. The dividend carries section 902 indirect foreign tax credits (and is increased by the section 78 gross up). USP is also entitled to an interest deduction for the $84 million of interest paid to the foreign counterparty and USP's subsidiary is entitled to a deduction for the $120 million it paid to SPV. For foreign income tax purposes, the foreign counterparty is treated as the owner of the SPV shares subject to the repo transaction and the

Jack Cummings
Editor

The Atlantic Building
950 F Street, NW
Washington, DC 20004-1404
202.756.3300
Fax: 202.756.3333

www.alston.com

One of *Fortune*® magazine's "100 Best Companies to Work For™"

This advisory is published by Alston & Bird LLP to provide a summary of significant developments to our clients and friends. It is intended to be informational and does not constitute legal advice regarding any specific situation. This material may also be considered attorney advertising under court rules of certain jurisdictions.

$84 million it receives from USP is treated as a dividend from SPV, which is exempt from foreign income tax under a participation exemption. At the end of the day, the foreign jurisdiction receives income tax payments from the SPV on the interest income equal to the payments it would have received on a direct loan from the foreign counterparty. The U.S. borrower obtains lower after-tax borrowing costs because it has in effect transformed interest deductions into foreign tax credits. The foreign counterparty is compensated by receiving a higher interest rate than it would have received in a straightforward loan.

In a "U.S. lender transaction," the U.S. lender's funds are advanced to the foreign counterparty through a complex structure involving hybrid and reverse hybrid entities and hybrid financial instruments designed to shift income and related foreign income taxes of the foreign counterparty to the U.S. lender for U.S. income tax purposes. At the end of the day, the foreign counterparty is able to obtain cheaper financing because of the U.S. lender's tax savings.

In an "asset holding transaction," a U.S. person transfers income producing assets to an SPV that is subject to foreign income tax on the income generated by the transferred assets. A foreign counterparty is treated as an owner of the SPV for foreign income tax purposes, but not for U.S. tax purposes. The result, in general terms, is that tax benefits associated with the foreign income tax paid by the SPV are shared by the parties.

Structured Passive Investment Arrangements

The proposed regulations provide that a foreign income tax payment or accrual that is attributable to a "structured passive investment arrangement" is not a compulsory payment and is not eligible for foreign tax credit benefits. A structured passive investment arrangement is an arrangement that satisfies six conditions representing features that are common to international tax arbitrage transactions.

The first condition is that the arrangement uses an entity (SPV) that meets the following two requirements: (i) substantially all of its gross income is passive income and substantially all of its assets generate passive income, and (ii) it makes a "purported" foreign income tax payment with respect to its income (either at the entity level or at the owner level in the case of a pass through entity). The second condition is that a U.S. person is eligible to claim a foreign tax credit for all or a portion of the foreign income tax paid or incurred by SPV. The third condition is that the foreign tax credit claimed by the U.S. person is substantially greater than the foreign tax credit the U.S. person would be entitled to if it owned a pro rata share of the assets owned by SPV through an arrangement that was not subject to full tax jurisdiction of the foreign country.

The fourth condition is that the arrangement generates some foreign tax benefit (including a credit, deduction, loss or payment) to a counterparty that is not related to the U.S. person. The fifth condition is that the counterparty not related to the U.S. person is considered under foreign income tax law to own at least 10 percent of SPV's equity, or to have acquired at least 20 percent of the SPV's assets. The sixth condition is that the U.S. and a foreign country in which a counterparty (or a related person) is subject to net basis income tax treat at least one of a number of aspects of the arrangement inconsistently under their respective income tax systems. The aspects of the arrangement subject to this requirement include: (i) classification of an entity as a corporation or as a fiscally transparent entity; (ii) characterization of an instrument as debt or equity or something that is disregarded for tax purposes; (iii) the proportion of the equity of the SPV that is considered owned by the U.S. person and the foreign counterparty; or (iv) the amount of taxable income of the SPV for one or more taxable years during the life of the arrangement.

Planning Considerations

Clearly, the proposed regulations represent a major offensive by Treasury and the IRS against what they perceive to be abusive foreign tax credit structures and, therefore, to state the obvious, taxpayers currently or planning on participating in such structures should exercise caution. We are skeptical, however, whether the six-part test in the proposed regulations to identify abusive structures will be totally effective. A structure only has to avoid one of the six attributes to escape the rule. The passive income requirement in the first condition and the requirement to compare alternate structures yielding lower foreign tax credit benefits in the third condition may be vulnerable points. Ultimately, the single critical factor in these structures is the ease of attaining inconsistent treatment of certain attributes of the structures under U.S. and foreign income tax law, in particular the classification of financial instruments as debt or equity. The hybridization of financial instruments does not rely on the check-the-box regime (undermining to some extent the many critics of that regime). Thus, the real solution to the problem is harmonization of U.S. and foreign income tax law; but of course this is unlikely to occur in the near future for many reasons. The result may be that the proposed regulations leave many planning opportunities.

For additional information please contact Kevin Rowe 212.210.9505 or Diana Wessells 202.756.3389.

If you would like to receive future issues of Alston & Bird's *International Tax Advisory*, please forward your contact information to **Internationaltax.advisory@alston.com**. Please put "subscribe" in the subject line.

International Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481

Edward Tanenbaum
Co-Chair
212.210.9425

Pinney L. Allen
404.881.7485

Gideon T. J. Alpert
212.210.9403

J. Bradford Anwyll
202.756.3432

Saba Ashraf
404.881.7648

John F. Baron
704.444.1434

Henry J. Birnkrant
202.756.3319

Robert T. Cole
202.756.3306

Philip C. Cook
404.881.7491

James E. Croker, Jr.
202.756.3309

Jasper L. Cummings, Jr.
202.756.3386

Eva Farkas.DiNardo
212.210.9592

Jennifer L. Dowell
404.881.4491

Tim L. Fallaw
404.881.7836

Terence J. Greene
404.881.7493

Michelle M. Henkel
404.881.7633

L. Andrew Immerman
404.881.7532

Akemi Kawano
202.756.5588

Andrea Lane
202.756.3354

Brian E. Lebowitz
202.756.3394

Clay Littlefield
704.444.1440

Edgar D. McClellan
202.756.3462

Nicki N. Nelson
404.881.4288

Timothy J. Peaden
404.881.7475

Kevin M. Rowe
212.210.9505

Gerald V. Thomas II
404.881.4716

Diana Wessells
202.756.3389

Charles W. Wheeler
202.756.3308