Regulations Denying Foreign Tax Credits in Structured Transactions Enter into Force

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I. OVERVIEW.

On July 15, 2008, the U.S. Treasury Department and the Internal Revenue Service adopted regulations that prevent taxpayers from claiming credits for foreign taxes paid in "structured passive investment arrangements" ("SPIAs"). The goal is to curb foreign tax credit arbitrage transactions that seek to achieve duplicative benefits from a single payment of foreign tax, one in the form of a credit by a U.S. party of the foreign tax against U.S. taxes, and a second benefit allowed to a foreign party under the tax laws of a foreign country. The SPIA regulations generally follow the principles of proposed regulations issued in March of 2007, but in some respects are significantly broader in scope. By their terms, they could apply in unanticipated ways to some conventional joint ventures. The regulations apply retroactively to foreign taxes paid or accrued in taxable years **ending** after July 15, 2008. As a result, the regulations could result in the disallowance of foreign taxes paid or accrued by a calendar-year taxpayer since January 1 of this year.

The SPIA regulations were issued in temporary and proposed form. This approach allows the regulations to enter into force immediately while giving taxpayers the opportunity to comment on, and suggest changes to, the regulations. Informal conversations with the drafters suggest that they are conscious of respects in which the regulations may be overbroad or imperfect, and expect to make fine-tuning changes between now and year-end. In the meantime, however, taxpayers must assume that the regulations mean what they say.

The preamble to the SPIA regulations indicates that the IRS will continue to scrutinize arrangements it believes to be inconsistent with the purpose of the foreign tax credit rules, and may issue further regulations to address them. Thus, tax credit arbitrage transactions that for some reason fall outside the scope of the regulations are not immune from challenge.

II. BACKGROUND.

The SPIA regulations are part of a continuing U.S. government assault on arbitrage transactions in which the payment of a foreign tax produces duplicative benefits. In these transactions, the U.S. party derives no economic benefit from paying a foreign tax and claiming a credit for the tax paid, but does receive a payment in some form from a foreign counterparty representing a portion of that party's foreign tax benefit. The policy concern appears to be that the counterparty's willingness to share the foreign tax benefit encourages the U.S. party to subject income to foreign taxation. The result is that U.S. tax is offset with the foreign tax, reducing government revenues.

Transactions in which a U.S. person and a foreign counterparty derive duplicative benefits as a result of differences between the U.S. and foreign tax systems are not uncommon. U.S. tax authorities have sought for almost 20 years to develop criteria for determining whether and how to challenge foreign tax credit arbitrage transactions.[1] During most of that period, taxpayers believed (and the U.S. tax authorities appeared to agree) that some tax credit transactions involving duplicative benefits were appropriate and others were not. A variety of transactions developed over time. There appeared to be no consensus within the government on where to draw the line. The 2007 proposed regulations suggested, and the SPIA regulations confirm, that the U.S. tax authorities have come to view virtually all such transactions as inconsistent with the principles of the foreign tax credit rules.

The SPIA regulations do not apply to foreign taxes paid in taxable years ending on or before July 15, 2008, but the preamble indicates that the IRS will continue to use all available tools under current law to challenge foreign tax credits claimed in transactions that it believes to be inconsistent with the purpose of the foreign tax credit rules. The preamble refers to the substance over form doctrine, the economic substance doctrine, debt-equity principles, tax ownership principles, the partnership anti-abuse rules, other provisions of the foreign tax credit regulations and section 269. The IRS has sought to apply a variety of theories, some of them novel, in recent administrative challenges to tax credit arbitrage transactions.[2] At least one transaction is already in the courts, and there are likely

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1 A 1989 protocol to the U.S.-German tax treaty provides a mechanism to address arbitrage transactions essentially similar to those described in the SPIA regulations; some more recent treaties include similar provisions. A previous attempt to develop generally applicable standards for evaluating tax credit arbitrage transactions was adopted in 1998 and withdrawn in 2004. *See* Notice 98-5, 1998-1 C.B. 334, withdrawn by Notice 2004-19, 2004-1 C.B. 606.

2 For example, in a recent Chief Counsel Advice involving a transaction that was potentially subject to challenge on a variety of grounds, the IRS argued (citing only the Congressional intent underlying the foreign tax credit rules), that the amount of foreign tax credits allowable to a U.S. participant should be reduced by the foreign tax savings realized by a foreign participant. *See* Tax Analysts, Document 2008-12368 (February 29, 2008). There is some tension between that approach and the rule of current

to be a number of others.[3] The outcome of these challenges will depend on the facts of particular transactions. Arguments that would apply to some transactions may not be relevant for others.

The regulations clarify that the new rules will not apply to foreign taxes imposed on a foreign subsidiary of a U.S. parent in a pre-effective date year because the income is brought back in a taxable distribution after the effective date of the regulations.

III. GENERAL COMMENTS.

The SPIA regulations do not include a general tax avoidance test based on intent. The relative importance of tax and non-tax reasons for entering into a transaction, and the relative weight of tax and economic benefits, have no bearing on whether the regulations apply. Instead, the drafters of the SPIA regulations took the approach of identifying objectively the characteristics of transactions that concerned them and denying credits only where those characteristics are present. The drafters achieved their objective, in the sense that the six identifying features listed by the regulations are characteristic of structured foreign tax credit arbitrage transactions. We are concerned, however, that the regulations may be overinclusive, because several of the identifying features are also commonly found in joint ventures and other business arrangements not involving tax arbitrage. It is impossible to predict whether and to what extent the SPIA regulations will have real-world consequences for transactions that are not within their intended scope. But it should be possible to reduce exposure to this concern, without compromising the policy objectives underlying the SPIA regulations, by making comparatively minor modifications to the six-factor test described below.

Under the regulations, a transaction will be an SPIA if it involves: (i) a special purpose vehicle ("SPV"); (ii) a U.S. party; (iii) claims to foreign tax credits for taxes in excess of those that would have been incurred in a hypothetical direct investment by the U.S. party; (iv) a foreign tax benefit for a counterparty; (v) a counterparty that owns some

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law that allows a taxpayer to claim credits for taxes that are directly reimbursed by a counterparty (*e.g.*, through a withholding tax gross-up).

3 IRS Chief Counsel Donald Korb said recently that a number of cases have been approved for litigation. *See IRS Looking at Joint International Exams, Korb Says*, 2008 TNT 134-1 (July 11, 2008). The IRS has designated foreign tax credit-related transactions as a Tier 1 issue (effectively restricting authority to settle audits at the local level), and has provided a model form of document request for revenue agents to use in identifying and collecting information concerning those transactions. *See IRS Alerts LMSB Field Specialists To Abusive Foreign Tax Credit Generator Transactions*, 2008 TNT 55-10 (March 11, 2008).

equity in or buys some assets from the SPV and is not linked by 80 percent ownership with the U.S. party;[4] and (vi) a difference in U.S. and foreign tax treatment.

If a transaction satisfies these six conditions, it will be an SPIA. The regulations give taxpayers no opportunity to establish that a transaction was not "structured" to incur additional taxes that produce duplicative benefits using a passive vehicle. Accordingly, taxpayers will not be able to avoid problems under the regulations (and avoid the need to consider whether they might apply) by just saying no to foreign tax credit arbitrage transactions. Further, a small duplication can produce a large loss of credits. The government rejected a plea to tie the amount of disallowed credits to those for which a duplicated benefit is claimed. The foreign tax benefit rule in the regulations makes it clear that the amount of disallowed credits may be as much as 10 times the amount of foreign taxes that are deemed to produce duplicative benefits. Indeed the ratio could be much higher, because there is no requirement that the taxes actually produce duplicative benefits, or even that they be intended to produce duplicative benefits.

Looking at the six factors critically, as described further below, the SPV definition is overbroad and may include active businesses (including most importantly holding companies owning subsidiaries engaged in active businesses). The direct investment test is written in such a way that it always appears to be met for any transaction in which a credit is claimed (the one case in which it might not have applied under the 2007 proposed regulations was eliminated in the new regulations). A foreign tax benefit may be present if available foreign benefits are as low as 10 percent of the creditable tax. The counterparty definition requires only that a person that is not 80 percent-owned by the U.S. party own equity in or acquire assets from the SPV (in each case, in any amount). There is no express requirement that the ownership or asset acquisition be responsible for the duplicated benefit. The inconsistent treatment factor requires an inconsistency that materially affects the U.S. tax treatment of the U.S. person, but not one that is tied to the required foreign tax benefit or to enjoyment of the credit. Some of the inconsistencies listed in the regulations are present in many routine transactions and ownership structures. For example, a U.S. check-the-box election to treat an entity as tax-transparent will do the trick. The same is true for any material difference in the timing of income or deductions (*e.g.*, a difference in cost recovery schedules for real estate or machinery).

What all this means is that an SPIA may be found in a wide range of transactions involving active foreign businesses where a U.S. person claims a credit for a

[4] More precisely, an entity that owns equity in or buys assets in the SPV will be a counterparty unless either (i) the U.S. party owns 80 percent of the entity, or (ii) both entities are owned, directly or indirectly, by a single 80 percent shareholder. For convenience, this memorandum generally uses the expression "80 percent-owned," and does not refer separately to the alternative 80 percent common control test.

foreign tax, and a foreign person that is not 80 percent-owned by the U.S. person derives a benefit in respect of 10 percent or more of the same tax. Those elements can be present in transactions not normally thought of as structured tax arbitrage transactions.

For example, suppose a foreign bank holding company has a number of active subsidiaries (*e.g.*, commercial banks and securities dealers). The bank holding company issues a type of preferred capital security that is viewed as equity (and is eligible for tax-advantaged treatment) for foreign tax purposes but is considered debt under U.S. tax principles. A foreign investor buys a significant amount of the securities and is entitled to receive distributions on the securities free of foreign tax. A U.S. investor acquires at least a 10 percent voting interest (the section 902 threshold for indirect credits) in the bank holding company, and does not also own 80 percent or more of the foreign holder of the preferred capital security. If the benefit to the foreign holder is deemed for purposes of the regulations to correspond to 10 percent or more of the foreign taxes paid by the bank holding company (including taxes of lower-tier entities that are pass-through entities for U.S. or foreign tax purposes), the U.S. shareholder apparently would be denied all credits for those otherwise creditable taxes.[5]

As another example, assume a U.S. party owns a 50 percent interest in a joint venture conducted through a U.K. holding company. One or more of the holding company's subsidiaries meets the definition of an SPV. Dividends received by the holding company from its U.K. subsidiaries will not be subject to U.K. corporation tax under a generally applicable exemption for intercorporate dividends. Dividends received from non-U.K. subsidiaries may be sheltered from U.K. taxation by foreign tax credits. Because the holding company would be a "counterparty" for purposes of the regulations (it is not 80 percent-owned by the U.S. party), U.K. tax rules that are intended solely to ensure that the same item of economic income is not taxed twice could constitute a foreign tax benefit that results in a loss of credits for taxes paid by the subsidiaries.

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5 The regulations provide that if a company is jointly owned by a U.S. party and a counterparty, and each is allocated its proportionate share of the taxes, then the benefit derived by the counterparty in respect of its share does not "correspond to" the taxes for which the U.S. party claims credits. In the example in the text, all of the foreign taxes would be allocated to the shareholders (including the U.S. party), because the capital security is treated as debt for U.S. tax purposes. The policy issue raised by the issuance of a hybrid instrument by an operating company seems to relate less to whether foreign taxes are compulsory (they relate to profits of an active business) and more to how taxes are allocated to the U.S. party. Section 902 allocates taxes based on how earnings and profits are allocated under U.S. tax principles. As a result, payments made to a foreign holder of a security treated as debt for U.S. purposes do not dilute credits available to U.S. shareholders. It may be questioned whether a regulation addressing noncompulsory taxes is the right place to address any deficiencies that may be thought to exist in section 902.

The first example above shows that the regulations can catch cases in which credits are claimed for taxes imposed on income derived by an established business (not involving the passive investment of new capital infusions) where the business seeks to raise capital, or reduce foreign tax costs, by issuing instruments that are tax-advantaged from the perspective of foreign investors. As applied in that context, the regulations bear some resemblance to the dual consolidated loss rules of section 1503(d). Those rules limit U.S. deductions for losses in cases where the same deductions may also reduce income of another person under foreign law. The SPIA regulations can function as a credit-related version of section 1503(d) that will deny credits for taxes imposed on business income if another party derives foreign tax benefits; those benefits correspond to 10 percent or more of the taxes allocable to the U.S. party; and the two parties are not linked by 80 percent ownership. It seems quite unlikely that this broad result was intended. The SPIA regulations are also similar to the dual consolidated loss rules in that the amount of credits that are denied can be significantly disproportionate to the amount of the duplicated benefit.

While it is unlikely that the IRS would reconsider its basic antipathy to structured foreign tax credit arbitrage transactions, the fact that the regulations were issued in proposed as well as temporary form suggests that the IRS expects to make further refinements, which could include changes that better aim the regulations at their intended targets. The potential overbreadth of the rules could be addressed by (among other possibilities) providing explicitly that the required elements of an SPIA must be part of a single plan (whether that is now required by the word "arrangement" is not clear); modifying the definition of SPV so that it catches entities that are designed to provide steady cash flows to support payments to a U.S. party or a counterparty, and not active businesses or asset pools with real risk; modifying the definition of direct investment so that it actually requires an incremental tax cost;[6] modifying the definition of "counterparty" to work properly in the case of jointly-owned entities; and requiring that the foreign tax benefit be *attributable* to a difference in treatment under U.S. and foreign law. It also would be very helpful to limit the amount of disallowed credits to the amount of the duplicative benefits

6 The drafters did not adopt comments encouraging them to provide an exception for transactions that do not result in a net increase in foreign taxes paid (for example, a transaction in which a U.K. subsidiary of a U.S. company incurs French tax costs that are completely offset by U.K. tax savings), because they concluded that it was not practical to craft an administrable rule. Notice 98-5 had been interpreted to allow taxpayers to net foreign tax costs and benefits in this manner. Efforts could be made to persuade the IRS to reconsider this judgment on the ground that the test need not be perfect in order to identify clear-cut cases in which incremental taxes are paid to generate duplicated benefits. Whether a tax is really an incremental tax can be a matter of debate. However, if an incremental tax were required, the test surely would be met in many or most of the structured transactions at which the regulations were aimed. Determining whether a tax cost is truly incremental will become more difficult as the facts depart from the classic structured transaction, but it seems unnecessary to avoid this difficulty by disallowing credits in every case.

claimed by the counterparty. The IRS rejected a number of these suggestions in formulating the SPIA regulations, but they should reconsider them. In our view they would not significantly limit the utility of the regulations as a tool to combat structured arbitrage transactions but would limit the risk of collateral damage.

A potentially noteworthy feature of the SPIA regulations is that, in cases where the U.S. and foreign treatment of a transaction is inconsistent, the foreign tax treatment determines the U.S. outcome even if the U.S. tax treatment clearly is more consistent with the economic substance of the transaction than the foreign treatment. It makes no difference whether the U.S. or foreign characterization is "right," or whether the duplicative benefits represent a cost to the U.S. tax system or the foreign system.

IV. DESCRIPTION OF THE REGULATIONS.

The SPIA regulations extend the application of existing U.S. tax rules that disallow credits for "noncompulsory" taxes paid to a foreign country[7] by deeming taxes to be noncompulsory if they are attributable to an SPIA. A transaction will be treated as an SPIA if it satisfies the conditions described below. The preamble states that the conditions are characteristic of arrangements that are designed to generate inappropriate foreign tax credit benefits. However, the regulations apply without regard to whether a transaction is motivated by tax considerations or has a significant non-tax business purpose, and without regard to whether the foreign tax payment in fact produces a corresponding duplicative benefit for another party.

As noted above, a transaction will be an SPIA if it involves: (i) a special purpose vehicle; (ii) a U.S. party; (iii) foreign tax costs in excess of those that would have been incurred on a hypothetical direct investment; (iv) a foreign tax benefit; (v) a counterparty; and (vi) a difference in tax treatment.[8] With the exception of "U.S. party" (the definition of which is straightforward), all of these terms have special definitions for purposes of the SPIA regulations. The 2007 proposed regulations applied the same six conditions but, as discussed below, the SPIA regulations include changes that significantly affect their scope.

7 Treasury regulation § 1.901-2(e)(5)(i).

8 The six conditions do not need to be met in the same year. Accordingly, it is not possible to avoid the application of the SPIA regulations by acquiring an interest in an SPV after a counterparty has derived foreign tax benefits, or disposing of the interest before the counterparty derives such benefits.

A. Special Purpose Vehicle.

An entity will be an SPV if substantially all[9] of its gross income is passive investment income, substantially all of its assets are held for the production of such income, and it makes a foreign tax payment in respect of that income. A holding company that owns operating subsidiaries will be deemed to be an SPV unless it qualifies for a special holding company exception.

"Passive investment income" for this purpose is defined by reference to the rules applicable for purposes of determining whether earnings derived by a foreign subsidiary of a U.S. company constitute subpart F income, with some modifications. The modifications include: disregarding favorable rules applicable to certain amounts received from related parties; further limiting a complex exception for active financing income by requiring that all of the activities required to generate that income be performed directly by the entity's own employees; and slightly expanding that exception by eliminating requirements that income be attributable to home-country activities.[10]

Even before taking account of these modifications, the subpart F rules contain a number of detailed technical requirements. A foreign corporation that is controlled by substantial U.S. shareholders necessarily will take account of those rules, and may take steps to minimize subpart F income. An entity that is not a corporation, is not controlled by substantial U.S. shareholders, or whose shareholders do not seek to defer U.S. taxation of income earned outside the United States, may take little or no account of subpart F. As a result, a foreign operating business, even a very substantial one, may derive significant income that would be considered passive for subpart F purposes, because there is no reason for it to structure its activities to avoid that classification. The requirements needed to qualify for the active financing exception are particularly complex. Accordingly, a foreign financial business that is not a corporation for U.S. tax purposes, or whose U.S. shareholders do not seek to retain earnings outside the United States, may derive a very high proportion of income that would be considered passive for subpart F purposes, because it

9 The drafters rejected suggestions that the regulations provide guidance concerning the "substantially all" requirement. An example in the regulations provides that an entity that derives $166 million of net active business income and only $3.3 million of interest income (an active-to-passive ratio of 49:1) does not derive substantially all of its income from passive sources. This example will not be of much use in determining where to draw the line.

10 Accordingly, in determining whether income eligible for the subpart F active financing exception also qualifies as nonpassive for purposes of the SPIA regulations, section 954(h)(3)(E) (attribution of related party employees) does not apply, and "foreign country" is substituted wherever "home country" is used in section 954(h).

cannot (or has no reason to) structure its activities to qualify for the active financing exception.

As indicated above, a holding company will be considered an SPV unless it satisfies two requirements. The first requirement is fairly straightforward. In applying the "substantially all" test at the level of the holding company, income derived from subsidiaries will be nonpassive only to the extent those subsidiaries derive at least half of their income from the active conduct of a trade or business. A banking, financing or similar business earns active income only if its income would not be passive income in applying the SPV test.[11]

The second requirement is more difficult. The regulations provide that the holding company exception is available only to the extent that the U.S. parties and counterparties share in substantially all of the holding company's opportunity for gain and risk of loss derived from qualifying subsidiaries. There are a number of common fact patterns in which this test might not be met. First, suppose that the holding company has issued equity or debt to third parties (neither the U.S. party nor the counterparty). In that case, it may be impossible for any combination of the U.S. party and counterparty to have substantially all of the upside or downside. Second, it is not uncommon for one party to an operating joint venture to hold a class of preferred interests (such as the capital security in the bank holding company example above in Part III), or for management investors to hold options (or a special class of stock) that gives them a very significant participation in future appreciation after other shareholders have derived a specified return. Finally, the exception does not apply if either the U.S. party or the counterparty acquired its equity interest in a sale-repurchase (repo) transaction, or if instruments that are treated as equity for foreign tax purposes are treated as debt for U.S. tax purposes.

The preamble acknowledges that the holding company exception will not apply to some companies with active operating subsidiaries, but justifies that result by saying that holding companies can be used to facilitate abusive foreign tax credit arrangements. This may be true, but the holding company rule by its terms reaches far beyond the troublesome cases, and the regulations make no attempt to distinguish the good from the bad. If a counterparty owns a security issued by a holding company whose assets consist solely of stock in subsidiaries, the counterparty is in the same position as if it invested directly in equity of the subsidiaries.

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[11] Income of a holding company will not constitute passive investment income if it is derived from qualified equity interests in entities that are predominantly engaged in the active conduct of a trade or business. A "qualified equity interest" is stock representing 10 percent or more of the total combined voting power *and* the total value of equity interests in the entity, but does not include any preferred stock. Treasury regulation § 1.901-2T(e)(5)(iv)(C)(6).

The SPIA regulations are based on the policy judgment that the use of a passive investment vehicle, and not the presence or absence of investment risk, is the appropriate touchstone for identifying tax credit arbitrage transactions. Arrangements involving the use of direct interests in an active operating company to produce duplicative benefits may be subject to challenge for other reasons, but they will not trigger the application of the SPIA regulations, even if one of the parties is assured of a risk-free return and a predetermined amount of duplicative tax benefits. By contrast, arrangements involving the use of a passive investment vehicle are subject to challenge even if both parties are common shareholders who share equally in gains and losses. Since passivity, and not credit quality or investment risk, is the determining factor for all other purposes under the SPIA regulations, it would seem inappropriate to create an irrebutable presumption that a holding company will be considered passive unless both parties share equally in gains and losses derived from its subsidiaries.

It may well be the case that the use of a holding company facilitates the creation of a segregated pool of passive assets in which both parties can participate separately from the businesses conducted at the operating subsidiary level. If that is the concern, it would seem to make more sense to drop the holding company rule and replace it with a rule that allows a portion of an entity to be treated as an SPV if it is created to hold passive assets in order to permit the duplication of benefits in a structured transaction. Such a rule would apply to holding companies if they are used to segregate passive assets in a structured transaction but would not pick up conventional holding companies that have more complex capital structures than just a single class of common stock.

The preamble indicates that the U.S. tax authorities intend to monitor the use of holding companies that facilitate foreign tax credit arrangements that they consider to be abusive, and may consider modifying or eliminating the holding company exception. If anything, the exception should be expanded.

B. U.S. Party.

An SPIA must involve a U.S. party that pays (or is considered to pay) foreign taxes and, but for the SPIA regulations, would be eligible to claim credits for all or a portion of the foreign tax.

One interesting part of the definition is that it does not require that the U.S. party have any minimum interest in the SPV. Accordingly, a U.S. party could be a passive investor that does not have control over the entity or access to detailed tax information relating to the SPV or its other owners.

C. Direct Investment.

The direct investment factor requires that the U.S. party's share of foreign taxes paid by the SPV be substantially greater than the taxes it would have paid if it owned its proportionate share of the SPV's assets directly. Assets held directly by a U.S. party generally would be subject to foreign taxation only if (1) the U.S. party has a permanent establishment or branch in the taxing jurisdiction that causes it to be subject to a net income tax; or (2) the return on the assets is subject to a foreign withholding tax. In applying the direct investment test, however, the U.S. party must assume that the assets are *not* held in a manner that would subject them to a net income tax. Under the 2007 proposed regulations, this meant that the only case in which the direct investment test might not be satisfied is where the asset is subject to a gross-basis withholding tax. The SPIA regulations eliminate from the test assets that produce income subject to gross-basis withholding tax. Accordingly, it would appear to be impossible for a U.S. party ever to fail the test, and the reason for having the test as drafted is not clear.

The purpose of the SPIA regulations is to identify transactions in which a U.S. party deploys funds outside the United States, and incurs additional foreign tax costs, in order to receive compensation for duplicative benefits from a foreign counterparty. That is the reason why the regulations deem the taxes to be noncompulsory (the taxpayer organized its affairs in order to incur foreign tax costs in excess of the amounts required to conduct its business activities). Accordingly, a test that asks if the transaction results in added foreign tax credits would be helpful in properly limiting the scope of the rules. In most structured foreign tax arbitrage transactions, it is quite evident that incremental foreign taxes are being paid. If this is not true in a particular case, then there is a legitimate question whether the rules should apply. It would be difficult to argue that foreign taxes are not compulsory if the U.S. party would have incurred them even if there had been no duplicative tax benefit, and no inducement provided by a counterparty.

As indicated above, however, the IRS and Treasury rejected suggestions that the SPIA regulations should not be applied to disallow credits for foreign taxes if the taxes substitute for *other* foreign taxes that the U.S. party would have incurred in the absence of the arrangement on the ground that it was not possible to identify the baseline in an administratively feasible way.

D. Foreign Tax Benefit.

The arrangement must reasonably be expected to result in a foreign tax benefit being "available" to a counterparty (as defined below) or a person related to that counterparty.[12] A foreign tax benefit includes a credit, deduction, loss, exemption, exclusion or other tax benefit, including the ability to surrender a loss,[13] in any jurisdiction in which the counterparty is subject to tax on a net basis. The regulations provide that the benefits need not be actually realized if it is reasonable to expect that they will be available.

The regulations thus require U.S. taxpayers to consider whether a foreign lender or joint venture participant *may* be expected to derive foreign tax benefits from a transaction, without regard to whether those benefits are an intended object of the transaction. Foreign tax benefits in any jurisdiction (not merely the one in which the SPV is based) must be taken into account. In cases in which the foreign benefit is derived from ownership of a transferable security, it may be necessary to take account of its tax treatment in more than one jurisdiction. Benefits derived by an affiliate of the counterparty must also be taken into account. Accordingly, if foreign taxes paid by a joint venture between two U.S. companies produce German tax savings for the German parent of one of the companies, those savings could constitute a foreign tax benefit from the perspective of both U.S. participants in the joint venture. The regulations do not appear to require that the benefits be "reasonably expected" at the inception of the transaction. Changes in the direct or indirect ownership of an interest in the SPV therefore could affect the determination as to whether the foreign tax benefit condition is satisfied.

In cases in which a transaction is not structured to achieve a duplicated benefit, it may be difficult to obtain tax information relating to the counterparty that would allow a U.S. person to determine if a foreign benefit is reasonably expected. The test is phrased in the passive voice as a requirement that "the arrangement is reasonably expected to result" in a benefit and thus does not identify whose expectations count. As noted above, the SPIA definition does not require that a U.S. party own any minimum interest in an SPV. Thus, the U.S. party could be a minority interest holder that does not have access to detailed information about the SPV and the tax posture of its other owners. It is not clear what the IRS would require in these circumstances for an investor to show that the SPIA definition is not met.

The regulations limit the definition of foreign tax benefit in one respect that may reduce the need to consider *de minimis* cases, by providing that the tax benefit must "correspond to" at least 10 percent of the U.S. party's share of the foreign taxes or the

12 Treasury regulation § 1.901-2T(e)(5)(iv)(C)(7) provides that two persons are related if one person directly or indirectly owns 50 percent or more of the value of the equity of the other person, or the same person directly or indirectly owns 50 percent or more of the value of the equity of both persons. It is unclear why a 50 percent test is applied to identify a counterparty's affiliates, and an 80 percent test is applied to identify the counterparty itself.

13 *See* Example 9.

foreign taxable income base. The phrase "correspond to" is not entirely clear. An example shows that in a 50-50 joint venture between a U.S. party and a counterparty, benefits derived by the counterparty from its pro rata share of taxes paid by the joint venture vehicle are not considered a benefit "corresponding to" the U.S. party's share of foreign taxes.[14] In other words, taxes allocated to the U.S. party can be segregated from those allocated to the foreign party, at least in some circumstances. In this case, at least, "correspond to" means "relate to," and not "is equal to or greater than."

If the counterparty holds preferred equity in a joint venture and the U.S. party holds common, foreign tax benefits realized by the counterparty that are attributable solely to its own share of the SPV's earnings and taxes should not constitute a foreign tax benefit for purposes of the SPIA regulations.[15] On the other hand, if the counterparty holds preferred equity that is treated as debt for U.S. tax purposes, then for U.S. purposes, all of the taxes of the issuer would be allocated to the common and none to the preferred, and it would seem that the foreign party would be deriving a benefit corresponding to the U.S. party's taxes. If this reading is correct, then it could be challenging to determine if the 10 percent threshold is met, because the counterparty's proportionate share of the SPV's income would vary from year to year depending on levels of profitability. One possible approach would be to apply the test based on reasonable expectations (a mid-point average of some kind), but the regulations provide no guidance regarding this point. What if the 10 percent test is expected to be met in some years but not in others?

The 10 percent test appears to be applied to each counterparty (and persons related to it) separately. Thus, if a class of preferred equity creates a benefit corresponding to 10 percent of the U.S. party's share of taxes and it is held by two unrelated holders, it

14 *See* Example 10.

15 It is not clear how the test would be applied if the U.S. and foreign country have different approaches to the measurement of income (as very likely would be the case). For example, suppose that a foreign country has a concept such as section 902 that allocates credits to the foreign party based on its share of earnings of the issuer as measured for foreign purposes. If the earnings for foreign purposes are lower than the earnings for U.S. purposes, the foreign investor may be granted a credit for taxes that would be allocated to the U.S person under section 902. Would such a case involve a benefit "corresponding to" the tax for which a credit is claimed? If so, then the SPIA rules could be invoked in a very wide range of cases involving preferred equity. Thus, if a U.S. parent owns all of the common equity of a foreign subsidiary that is a holding company for foreign operating entities and the holding company issues preferred stock to a foreign investor representing a share (as determined for foreign tax purposes) of the U.S. party's taxes, the SPIA rules could apply to deny credits to the U.S. parent. Suppose that the preferred equity was transferable and perpetual. How could the U.S. parent ever know if the test is met? How would it administer a "reasonable expectations" test? Note that the 2007 proposed regulations required that the arrangement be "structured" to result in a foreign benefit, which implied that the benefit be an intended result.

would seem that the test is not met. This is a critical point in applying the regulations to arrangements in which equity securities are issued to a wide group of investors, and it would be helpful if the regulations confirmed the point expressly.[16]

It is important to note that the foreign tax benefit condition does not require that there be any formal or direct link between foreign taxes paid by the SPV and foreign tax benefits derived by the counterparty. In many foreign tax credit arbitrage transactions, there is no such link, or only a tangential and indirect link. If a counterparty derives a foreign tax benefit that is not clearly and directly linked to its share of an SPV's earnings and taxes, the IRS is likely to argue that the benefit "corresponds to" the U.S. party's share of the foreign taxes.

E. Counterparty.

The arrangement must involve a "counterparty." A counterparty is a person (other than an entity that is 80 percent-owned by the U.S. party) that is considered to own or acquire directly or indirectly any amount of equity in or assets of the SPV under the laws of a jurisdiction in which it is subject to tax on a net income basis. There is no explicit requirement that the equity interest or assets be responsible for the foreign tax benefit.

As illustrated by the second example in Part III above, this broadening of the definition to include related parties not linked by 80 percent ownership significantly increases the potential that ordinary course joint ventures will fall within the scope of the regulations.

The 2007 proposed regulations had included rules concerning the application of the compulsory payment rules to group relief systems (such as the U.K. system), which allow losses to be surrendered between related parties. These rules, which for the most part were intended to be taxpayer-friendly, provided that taxes would not be considered noncompulsory if losses were surrendered within a group that was 80 percent-owned by one U.S. owner. A number of commentators noted that the rules created the inference that surrenders of losses attributable to interests of a joint venture could result in the loss of credits for a participant (even if the losses were apportioned among participants in proportion to ownership interests) if the participant did not itself own an 80 percent interest in the joint venture. Responding to these concerns, the IRS announced in November of 2007 that it would deal with this aspect of the 2007 proposed regulations separately, and would

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16 The preamble describes the 10 percent rule as a replacement for a rule in the 2007 proposed regulations that required a counterparty to own 10 percent or more of the equity of the SPV in order to exclude cases in which the counterparty derives only a nominal foreign tax benefit. This explanation is consistent with applying the 10 percent threshold separately to each counterparty.

make the group relief changes only prospectively.[17] Joint ventures that dodged the bullet of adverse group relief rules may now find that they are subject to the disallowance of credits under the SPIA rules, again with a retroactive effective date. It seems reasonable to assume that this outcome was unintended and hopefully this aspect of the SPIA rules will be changed. Until that happens, however, and the precise text of the corrected rules is known, it will be necessary to at least consider the potential adverse effects of the regulations on joint ventures having nothing to do with structured arbitrage transactions.

F. Inconsistent Treatment.

The arrangement must be treated differently for U.S. and foreign tax purposes in one of the four following respects (which have not changed from the 2007 proposed regulations): (a) classification of the SPV as a taxable or as a pass-through entity; (b) characterization of an instrument issued by the SPV as equity, debt, or disregarded; (c) the proportion of the equity of the SPV treated as owned by the U.S. party and the counterparty; and (d) the amount of the SPV's taxable income for one or more taxable years during which the arrangement is in effect. Differences at the level of an entity with an ownership interest in the SPV can also satisfy the inconsistent treatment condition.

The 2007 proposed regulations had required that the inconsistent treatment materially affect the amount of foreign tax credits available to or income recognized by the U.S. party. The SPIA regulations modify this rule slightly by measuring the significance of a difference in treatment by reference to the credits that would have been available if the foreign tax treatment had applied for U.S. tax purposes. The regulations do *not* require that the difference in treatment contribute to, or be related to, intended foreign tax benefits of the counterparty. Thus, for example, in the joint venture example in Part III above, a difference in entity classification or in the timing of income could cause the inconsistent treatment condition to be met even if the difference has nothing to do with the reason for creating a holding company structure that gave rise to the foreign benefit.

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