INTERNATIONAL DEVELOPMENTS

FOREIGN TAX CREDIT GENERATORS

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Suppose that you are a bank or other financial institution in New York, and that you have funds you can make available to creditworthy businesses in Europe. You advance $1 billion to an internationally known European retailer that needs financing to expand its operations to new countries around the world, or perhaps $2 billion to a top-ranked European bank in need of an influx of Tier 1 Capital. You eventually get your money back, with a healthy rate of return. What transaction could possibly have a more legitimate business purpose?

Or suppose that you are a European financial institution with funds available for deployment into the United States. You advance $1 billion or perhaps $2 billion to a multinational manufacturer based in the United States and get your money back right on time and, once more, with a healthy rate of return. Can anyone possibly say that this transaction lacks profit motive?

But suppose now that before you entered into either of these transactions, you first talked to your accountant or your tax lawyer and they explained that, under current U.S. and European tax rules, you can structure a transaction that will give you a better return at a lower cost to the borrower? Why wouldn't you want to know more? Why wouldn't you heed your advisor's sage advice?

That, of course, is what many lenders did in the 1990s and early 2000s, and the result was a variety of transactions the IRS has disparagingly called “foreign tax credit generators.” The IRS has had little success in challenging these transactions on technical grounds; the simple fact is that, by and large, they actually work under the Byzantine rules of the Code and regulations. So the IRS has resorted to challenging these transactions on the generic grounds of “no business

purpose” and “no profit motive”—terms that must be stretched pretty far to describe genuine transactions between unrelated parties that involve real movements of billions of dollars and substantial economic benefits to all concerned.

Description of typical foreign tax credit generators

To begin the discussion, let us describe four structures that the IRS has attacked as abusive foreign tax credit generators.

The *Pritired* Case [1]

In the year 2000, Principal Financial Group and Citigroup formed a U.S. limited liability company, Pritired 1, LLC (“Pritired 1”), that in turn formed a wholly owned limited liability company, Pritired 2, LLC (“Pritired 2” and, together with Pritired 1, “Pritired”). Pritired entered into an agreement with two French banks, Natexis Bank and Bred Banque Populaire (the “French Banks”), under which Pritired and the French banks formed a French limited liability company (“FrenchCo”) that elected to be treated as a partnership for U.S. tax purposes. The capital structure of FrenchCo included two classes of shares, a convertible note, and perpetual certificates. The Class A shares and the convertible note were purchased by the French Banks for $930 million. The Class B shares and the perpetual certificates were purchased by Pritired for $300 million. FrenchCo used the funds received from its owners to purchase commercial securities from affiliates of the French Banks. Overall, these transactions resulted in a net transfer of $300 million from the United States to France.

At the beginning of the transaction, the Class A shares had 98% of the voting rights and were entitled to 99% of FrenchCo's profits after payments on the convertible note and the perpetual certificates. The Class B shares had 2% of the voting rights and were entitled to 1% of distributable profits. After 12/31/05, the voting rights of the Class A shares automatically fell to 50.1%, while the voting rights of the B shares automatically increased to 49.9%, and the holder of the B shares gained the unrestricted right to buy Class A shares sufficient to increase its voting by 0.2%. After 12/31/05, therefore, Pritired had the unilateral right to liquidate FrenchCo.

The terms of the convertible note and the perpetual certificates were specified in detail by the operative documents. The relationship between Pritired and the French Banks was set out in

detail in the operating agreement of FrenchCo. Overall, under these documents, Pritired expected to receive a pre-U.S.-tax return of LIBOR[2] plus 4.95% less French taxes.

Interest rates declined dramatically after these transactions were put in place, and Pritired's LIBOR-based returns correspondingly declined. However, interest rate floors that were part of the overall transactions meant that the reported income and reported French income taxes of FrenchCo did not decline nearly as much as the return paid to Pritired. For example, by 2002, because LIBOR had declined from 6.70% to approximately the range of 1.80% to 2.05%, Pritired was not entitled to any distribution under the FrenchCo documents but FrenchCo nonetheless had substantial earnings for French tax purposes and paid French income taxes of approximately $24 million. The allocation of the French taxes to Pritired allowed Pritired's partners to eliminate any U.S. taxes on their income from FrenchCo and, in addition, to offset their U.S. taxes on other foreign source income. Taking into account these “excess” foreign tax credits, the overall transactions generated an approximately 8% after-U.S.-tax return for the two U.S. partners.

The details of this transaction are complicated, but it is critical that the transaction involved three separate instances of cross-border arbitrage. First, FrenchCo itself was treated as a corporation for French income tax purposes but as a partnership for U.S. income tax purposes. Second, the convertible note was treated as controlling equity for French income tax purposes but as preferred equity carrying limited but guaranteed payments—and thus very much like debt—for U.S. income tax purposes. Finally, the perpetual certificates were treated as debt for French income tax purposes but as equity for U.S. income tax purposes.

The American International Group (AIG) transaction.[3]

In this case, AIG formed subsidiaries in France, New Zealand, Ireland, and the Cayman Islands (the “Financing Subsidiaries”). Acting through a wholly owned domestic subsidiary, AIG capitalized the Financing Subsidiaries with common and preferred stock. AIG then sold the preferred stock to unrelated foreign banks (the “Foreign Banks”) under repurchase agreements. The Foreign Banks' capital contributions to the Financing Subsidiaries typically exceeded AIG's contributions by one to three times.[4] Under U.S. tax law, the sale and repurchase arrangements were treated as secured loans. Under foreign tax law, however, the transactions were treated as purchases of the preferred stock by the Foreign Banks. The Financing Subsidiaries invested their capital in portfolios of income-producing debt securities.

The Financing Subsidiaries were controlled foreign corporations (CFCs) as to AIG because the Foreign Banks' share purchases were treated as secured loans for U.S. tax purposes. As the U.S. shareholder, AIG was required to include the income of these CFCs in its own U.S. income as Subpart F income. AIG was also, however, deemed to pay all the foreign income taxes paid by the Financing Subsidiaries. Because the Foreign Banks' investments were treated as equity in the foreign jurisdictions, the Financing Subsidiaries did not take deductions for interest in computing its taxable income. In computing its U.S. taxable income, however, AIG did deduct its payments to the Foreign Banks as interest. The result, as in the *Pritired* case, was that AIG claimed foreign tax credits well in excess of the U.S. tax on the U.S. taxable income generated by these transactions, and used the “excess” credits to offset the U.S. tax on other foreign-source taxable income.[5]

The arbitrage in this transaction was created entirely by the different characterization of the financing arrangements between the United States and the foreign jurisdictions. The foreign authorities considered the Foreign Banks' share purchases to be true equity investments. In the U.S., the shares are treated as a secured loan generating an interest deduction and AIG was allowed to claim its pro rata share of the foreign taxes paid.

The Foppingadreef transaction.[6]

In this transaction, Hewlett Packard (HP) used a contingent interest note to generate foreign tax credits. The company formed a subsidiary in the Netherlands Antilles (“Foppingadreef”), with HP acquiring preferred shares in the entity. Foppingadreef was managed and controlled in the Netherlands. It invested its entire capital in contingent interest notes issued by ABN-AMRO, a Dutch bank. The contingent interest notes provided two forms of return to Foppingadreef—semiannual base interest that was paid currently and contingent interest that would not be paid until 12/31/06, and only if certain contingencies occurred. Foppingadreef paid Dutch income taxes on a tax base that included both the base interest and the accrued but unpaid contingent interest. Foppingadreef proceeded to pay the base interest over to HP as dividends on its preferred shares. Because Foppingadreef was a controlled foreign corporation, HP had to include its share of Foppingadreef's income in its own U.S. income as Subpart F income. For U.S. tax purposes, however, the income included only the base interest. The contingent interest was not includable in U.S. income because the right to receive the contingent interest had not become fixed and it

was not possible to determine the amount of contingent interest that would be paid when the notes matured. Nonetheless, HP was deemed to have paid its proportionate same share of Foppingadreef's Dutch income taxes. It thus generated “excess” foreign tax credits that it could use to “shelter” other foreign source income.[7]

The Foppingadreef transaction was driven by the asymmetrical treatment of contingent interest for U.S. and Dutch tax purposes.

The Sovereign Bank STARS transaction.[8]

In this transaction, Sovereign Bank established a trust under Delaware law that was disregarded for U.S. income tax purposes. Sovereign Bank funded the trust with $4.6 billion worth of income-producing assets, receiving in exchange approximately $3.9 billion in Class A trust units and $750 million in Class B trust units. Barclays Bank purchased three other classes of trust units in exchange for $750 million in cash; however, under a collateral agreement, an affiliate of Sovereign Bank agreed to repurchase these units.[9] The affiliate of Sovereign Bank agreed to pay Barclays a LIBOR based return. The Delaware trust used Barclays' contribution to redeem the Class B trust units subscribed to by Sovereign Bank. Because a repurchase agreement is treated as a secured loan for U.S. income tax purposes, the units purchased by Barclays are owned by Sovereign Bank for U.S. tax purposes.

Sovereign Bank created an entity in the U.K. that was appointed trustee of the Delaware trust. The trustee was disregarded for U.S. tax purposes, but because the trustee's central management and control was in the U.K, the trustee was a U.K. resident company for tax purposes. Under U.K. tax law, a trust that is managed and controlled in the U.K. is a taxable entity in the United Kingdom.[10] As a U.K. tax resident, and pursuant to the applicable U.K. tax rules, the trustee was liable for U.K. income tax at a rate of 22% on the income earned by the Delaware trust. The trustee was legally liable for the tax and thus would be the taxpayer under the existing foreign tax credit regulations of Section 901. The trustee paid U.K. income taxes on the Delaware trust income and Sovereign Bank claimed a credit under Section 901 because the trustee was a disregarded entity. Under the U.S.-U.K. income tax treaty, Sovereign Bank's income generated by the assets of the Delaware trust was treated as foreign source income because it was subject to tax in the United Kingdom.

Pursuant to the Delaware trust agreement, Barclays was entitled to 99% of the trust's income. The Delaware trust distributed the after-tax proceeds to a blocked account owned by Barclays, and Barclays was obligated to immediately recontribute the distributions to the trust. These distributions and recontributions were disregarded for U.S. federal income tax purposes. Barclays was subject to tax on the distributions it received from the Delaware trust but was entitled to a credit for taxes paid by the trustee on the Delaware trusts' income. Thus both Barclays and Sovereign Bank were able to claim a credit for the taxes paid by the trust.

The recontributions to the trust were deductible by Barclays.[11] Barclays was subject to tax at a rate of 30% on the distributions but got a credit for the income taxes paid by the trustee, which were at a 22% rate. Barclays then got a deduction at 30% for the recontributions. The value of the deductions at 30% was worth more than the net tax that Barclays had to pay on the distributions, resulting in a net tax benefit.

Barclays used part of the tax benefit from the deduction of the recontributions to provide Sovereign Bank with a preferable rate on the repurchase agreement. Sovereign Bank was thus able to finance $750 million at 300 basis points below its normal financing rates.

Responses of the Treasury Department and the IRS

The IRS appears to have had problems articulating challenges to these foreign tax credit generators based on the technical requirements of the Code and regulations because, from the beginning, it has relied primarily on non-statutory doctrines such as “economic substance” and “no profit motive.” Thus, for example, in Chief Counsel Memorandum 200826036, the Service evaluated a transaction nearly identical to the STARS transaction discussed above and found that the trust device lacked economic substance because it had no substantive effect on the ownership or control of the taxpayer's assets or on the right to the income from those assets. The IRS further determined that the trust device was not motivated by any legitimate non-tax purpose and that the sole purpose was to generate foreign taxes that the taxpayer could claim as credits.

Partnership allocation regulations.

In April 2004, the Treasury Department released temporary regulations addressing the allocation for foreign taxes in partnerships.[12] The proposed regulations were targeted at transactions similar to *Pritired* where foreign taxes were allocated pursuant to a partnership agreement.

In general, partnerships are allowed to allocate items of income, gain, loss, deduction, and credit between partners as they see fit, provided the allocations have substantial economic effect. The temporary regulations provided that partnership allocations of creditable foreign tax expenditures cannot have substantial economic effect and, therefore, must be allocated in accordance with the partners' interests in the partnership. The temporary regulations provided a safe harbor in cases where the economic effect requirements of Reg. 1.704-1(b)(2) are satisfied and the partnership agreement provides for the allocation of creditable foreign tax in proportion to the partners' distributive shares of income to which the creditable foreign tax relates.

In October 2006, final regulations regarding the allocation of foreign taxes were issued.[13] The final regulations retain the provisions that the allocation of creditable foreign taxes cannot have substantial economic effect and provide a safe harbor under which allocations will be deemed to be in accordance with the partners' interests in the partnership. Under the final regulations, an allocation of a creditable foreign tax is deemed to be in accordance with the partners' interests in the partnership if it is in proportion to the distributive shares of income to which the creditable foreign tax relates and the allocations of all other partnership items that have a material effect on the allocation of creditable foreign taxes are valid.

Compulsory payment regulations.

In March 2007, the Treasury Department released proposed regulations targeted specifically at foreign tax credit generators.[14] The proposed regulations were revised into temporary regulations in July 2008 and final regulations with slight modifications were issued July 2011.[15] The approach of the final regulations is to use the compulsory payment requirement under the foreign tax credit regulations to deny a credit for taxes paid under foreign tax credit generator arrangements.

To be creditable, a foreign levy must be a tax and the tax must have the predominant character of an income tax in the U.S. sense.[16] A foreign levy is a tax if it requires a compulsory payment pursuant to a foreign government's authority to levy taxes.[17] The regulations provide that an amount paid is not compulsory to the extent that the amount exceeds the amount of liability the taxpayer would incur if the taxpayer interpreted and applied the provisions of foreign law to reduce over time its reasonably expected foreign tax liability.[18]

Generally, the new regulations provide that a foreign tax payment is not a compulsory payment if it is generated in a transaction where tax items are treated inconsistently between the United States and a foreign jurisdiction and a foreign counterparty is reasonably expected to receive a tax benefit. This approach targets the main arbitrage element of the foreign tax credit generators, which is exploiting the inconsistencies between tax jurisdictions.

More specifically, the new regulations provide that amounts paid that are attributable to a “structured passive investment arrangement” are not compulsory payments. An arrangement is a “structured passive investment arrangement” if it satisfies the following six criteria:

> (1) Substantially all of the gross income of the entity at the center of the arrangement must be passive investment income as described in Section 954(c), with slight modifications, and substantially all of the entity's assets are held to produce passive investment income.
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> (2) A U.S. person must be eligible to claim a credit under Section 901(a) for all or a portion of a foreign tax payment.
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> (3) The U.S. person's proportionate share of the foreign payment must be substantially greater than the amount of credits that the U.S. party reasonably would expect to be eligible to claim under Section 901(a) for foreign taxes if the U.S. person directly owned the assets.
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> (4) The arrangement must be reasonably expected to result in a credit, deduction, loss, exemption, exclusion, or other tax benefit under the laws of a foreign country that is available to a counterparty.
>
> (5) The arrangement must involve a counterparty who is a person subject to the tax laws of a foreign country on the basis of place of management, place of incorporation, or otherwise subject to net basis tax.
>
> (6) The United States and the foreign country must treat inconsistently either: the classification of the entity as a corporation or partnership; the characterization of the instrument as debt, equity, or a disregarded instrument; the proportion of the entity's equity considered owned by the U.S. party; or the amount of taxable income attributable to the entity.

It is not at all clear that the revised regulations make sense as a gloss on the meaning of the term “compulsory payment” since the taxes at issue have been legally imposed and properly paid in the foreign countries involved. Nonetheless, the new regulations are quite narrowly targeted and strongly focused on the core of tax arbitrage, that is to say, on the manipulation of differences between U.S. tax laws and the tax laws of other countries.

Technical taxpayer regulations.

Only the taxpayer subject to foreign tax can claim a credit for the tax. Applying this principle, the foreign tax credit regulations under the Section 901 regulations have long provided that a person will not be considered to have paid or accrued a foreign tax unless the person bore the legal liability for the tax under foreign law.[19] In August of 2006, however, the Treasury issued proposed regulations revising the legal liability rule in situations involving hybrid entities and certain foreign consolidated groups in which the members do not have full joint and several liability. The proposed regulations created a presumption that legal liability for a levy is imposed under foreign law on the party required to include the associated item of income in the foreign tax base.[20]

The proposed amendments to the technical taxpayer regulation were issued in response to the Claims Court decision in *Guardian Industries.*[21] In the *Guardian* case, the U.S. parent of a wholly owned Luxembourg subsidiary validly elected to treat the subsidiary as a disregarded entity. The subsidiary was itself the parent of an affiliated group of corporations and, under Luxembourg law, the subsidiary as parent was solely liable for the group's tax liability (i.e., there was no joint and several liability among the members for the group's consolidated Luxembourg tax liability). The U.S. parent claimed a direct FTC for the group's aggregate tax liability and sued for a refund when it paid an assessment based on a denial of that credit. The Court of Federal Claims awarded the refund to the taxpayer, sustaining its assertion that it was the technical taxpayer of the group's Luxembourg taxes under applicable foreign law.

On 2/9/12, the Treasury released final revisions to the technical taxpayer regulations.[22] Under the final regulations, if foreign tax is imposed on the combined income of two or more persons, foreign law is considered to impose legal liability on each such person for the amount of the tax that is attributable to such person's proportionate share of the combined income. Under the regulations, tax is imposed on the combined income of two or more persons if such persons

compute their taxable income on a combined basis under foreign law and foreign tax would otherwise be imposed on each such person on its separate taxable income.

Legislative responses

In August 2010, as part of the Education Jobs and Medicaid Assistance Act, Congress enacted two new provisions aimed at curbing the use of the foreign tax credit—Section 909 and Section 901(m). While these amendments may not impact all (or any) of the foreign tax credit generator transactions discussed above, they are relevant because they represent continued efforts to stop perceived abuses of the foreign tax credit.

Section 909 provides that the recognition of foreign income taxes paid or accrued by a U.S. taxpayer or its controlled foreign subsidiary is suspended for foreign tax credit or deduction purposes until the taxpayer recognizes the related income—if there is a foreign tax credit splitting event with respect to the foreign income tax. It is important to note that Section 909 defers credits for foreign taxes when the taxes are separated from the foreign income that produced them. Section 909 does not suspend foreign income taxes if the same person pays the tax but takes into account the related income in a different taxable period due to, for example, timing differences between the U.S. and foreign tax accounting rules. Thus, it appears that Section 909 would not reach transactions such as that in Foppingadreef.

The new rules of Section 909 are focused on transactions among *related* parties that produce foreign tax credits without the corresponding foreign income. Thus, a foreign tax credit splitting event occurs when related income is taken into account for U.S. purposes by a *covered* person and a “covered person” is defined to mean, with respect to any person who pays or accrues a foreign income tax (the payor): (1) any entity in which the payor holds, directly or indirectly, at least 10% ownership interest; (2) any person that holds, directly or indirectly, at least a 10% ownership interest in the payor; (3) any person that bears a relationship to the payor described in Sections 267(b) or 707(b) ; and (4) any other person specified by the regulations.

The Joint Committee on Taxation Technical Explanation of the provision provides an example of a foreign tax credit splitting event. In the example, U.S. Corp., a domestic corporation, wholly owns CFC1, a country A corporation. CFC1, in turn, wholly owns CFC2, a country A corporation. CFC2 is engaged in an active business that generates $100 of income. CFC2 issues a hybrid

instrument to CFC1. The instrument is treated as equity for U.S. tax purposes but as debt for foreign tax purposes. Under the terms of the hybrid instrument, CFC2 accrues (but does not pay currently) interest to CFC1 equal to $100. As a result, CFC2 has no income for country A tax purposes, while CFC1 has $100 of income, which is subject to country A tax at a 30% rate. For U.S. tax purposes, CFC2 still has $100 of earnings and profits (the accrued interest is ignored since the United States views the hybrid instrument as equity), while CFC1 has paid $30 of foreign taxes. Under the provision, the related income with respect to the $30 of foreign taxes paid by CFC1 is the $100 of earnings and profits of CFC2.

A splitter event occurs when a different person incurs tax liability from the person that earned the income for U.S. tax purposes. The foreign tax credit splitter rule is required because, generally, under the technical taxpayer rule, a foreign tax credit is attached to the taxpayer that actually incurs the technical liability for a foreign tax.[23]

On 2/9/12, the IRS issued temporary regulations under Section 909.[24] The regulations provide the exclusive list of arrangements that are treated as giving rise to foreign tax credit splitting events for purposes of applying Section 909 for tax years beginning on or after 1/1/12.[25] Foreign income taxes that are paid or accrued in connection with a splitter arrangement will not be taken into account before the tax year in which the related income is taken into account by the payor.

The temporary regulations follow the approach of Notice 2010-92 by identifying specific arrangements that will result in the application of Section 909. The four types of arrangements that can cause foreign taxes to be suspended under Section 909 are the following:

> (1) A reverse hybrid structure (an entity treated as a corporation for U.S. tax purposes but as a pass-through entity by the relevant foreign country). In such a structure the reverse hybrid will be treated as earning the income for U.S. tax purposes, but because it is transparent the parent of the reverse hybrid will incur the tax liability for foreign tax purposes.
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> (2) A foreign group relief or loss-sharing regime (a regime in which one entity may surrender its loss to offset the income of one or more other entities). A loss-sharing splitter arrangement is defined as arising under a foreign group relief or other loss-sharing regime to the extent a shared loss of a U.S. combined income group could have

been used to offset income of that group but is used instead to offset income of another U.S. combined income group.

(3) Hybrid instruments that are treated as debt for U.S. tax purposes but as equity for foreign tax purposes, or vice versa.

(4) Inter-branch payment splitter arrangements to the extent the tax on the inter-branch payment is not allocated to the partners in same proportion as the distributive shares of income.

Court cases

The legislative and regulatory efforts described above do not apply retroactively and thus the question remains what happens to the hundreds of millions of dollars of foreign tax credits that have already been claimed in foreign tax credit generator transactions. These cases will have to be decided by the courts.

The *Pritired* case.

The U.S. District Court for the Southern District of Iowa is the first court to enter the fray. The gist of its thinking comes through clearly in the first paragraphs of the *Pritired* opinion, when the court states:

> Through this transaction, the French banks were able to borrow three hundred million dollars at below market rates. The American companies received a very high return on an almost risk free investment. Only one thing could make such a transaction so favorable to everyone involved. United States taxpayers made it work.

While the government presented the court with few arguments based on the actual Code and regulations, it was successful in convincing the court that the foreign tax in question was generated by a foreign corporation that was not a corporation, capitalized with equity that was not equity, and paying foreign income taxes on what was not income.

More specifically, the court found that the Class B shares and the perpetual certificates were in the nature of a loan and not equity, with the result that Pritired was not a partner in FrenchCo and FrenchCo was not a partnership. The court relied on the factors expressed by the IRS in Notice

94-47 and common law[26] in conducting its debt versus equity analysis, focusing on (i) characterization (i.e., form), (ii) market risk, (iii) credit risk, and (iv) voting rights. The court found that the changing voting rights and associated liquidation provisions resulted in the expectation of repayment of a sum certain on a finite date of maturity, an entitlement in Pritired to ongoing payments during the term of the "loan," with limited upside or downside potential. The court also found that the transaction had no economic substance because the subjective business purpose of the taxpayer was to enhance low-yield investments through the foreign tax credit and there was no reasonable possibility of profit. Finally, the court found that the transaction violated the partnership anti-abuse rule because a valid partnership was not formed, in substance the transaction was a loan, and the special allocation of French taxes to Pritired was inconsistent with the intent of Subchapter K.

The Foppingadreef transaction.

The Foppingadreef transaction (contingent interest note) is the subject of litigation in two cases currently pending. *Hewlett-Packard,* was argued before the Tax Court in September 2010, and a decision is pending. The IRS argued that the foreign tax credits should be disallowed under common law doctrines, including economic substance and substance over form.[27] The IRS also argued that Hewlett-Packard's investment in Foppingadreef should be characterized as a loan.

The *AIG* case.

AIG's system of cross border financing (foreign subsidiary capitalized by foreign banks pursuant to repurchase agreements) and a transaction identical to Foppingadreef are the subject of litigation in the Southern District of New York. AIG's motion for summary judgment was denied in March 2011 and the case is proceeding with discovery. In its brief opposing summary judgment, the government relied on identical arguments to the *Hewlett-Packard* case in addressing the Foppingadreef transaction, once again arguing that AIG did not have a legitimate business purpose for entering into the transaction apart from tax avoidance and that there was no reasonable opportunity for profits apart from the tax benefits. The government also challenged the claimed foreign tax credits on the basis that Foppingadreef was not a controlled foreign corporation. Finally, the government has asserted that AIG's investment in Foppingadreef was a loan and not an equity investment. Initially the government challenged AIG's cross border

financing on the basis that it did not bear the economic burden of the foreign taxes paid.[28] The government has also asserted that the transactions lack economic substance.

The STARS cases.

The STARS transaction is the subject of litigation in five cases.[29] The IRS has principally relied on common law doctrines to disallow the foreign tax credits. The government alleges that the transactions lack economic substance and business purpose and there was no rational connection between the taxpayer's asserted purpose of obtaining low-cost financing and the structure of the transaction.

Conclusion

Foreign tax credit generators are complex transactions that exploit inconsistent treatment of the same transactions under the tax laws of different jurisdictions. The IRS has been adamant that it will not accept transactions structured to produce foreign tax credits without the associated income, but it has generally failed to fault these transactions from a technical point of view. Instead, it has fallen back on common law doctrines such as “no business purpose” and “no non-tax profit motive.”

Recently, the IRS has invoked the rules designed to distinguish debt from equity. There is, of course, a long line of cases in this area, not to mention spectacularly unsuccessful attempts at defining the difference between debt and equity by legislation and/or regulation. The court in *Pritired*, following the lead of the IRS, professes to apply the debt-equity rules but it is clear from the outset of the court's opinion that it will bend those rules as far as it must to find in favor of the government.

The government has a legitimate problem with tax-motivated transactions such as the foreign tax credit generators discussed in this article. But the answer cannot be to rewrite the already murky area of debt versus equity. The critical problem in *Pritired* was the permissive rule for allocations of foreign tax credit that appeared in the partnership allocation regulations under Section 704; the simplest way to fix that problem would be to amend those regulations. The pinpointed approach of the new “compulsory payment” regulations may prove too detailed to be effective—in this respect, it is reminiscent of the “conduit” regulations under Section 881[30] that did not successfully dissuade the Canadian taxpayer in *Del Commercial Properties*[31] from engaging in a more

sophisticated form of treaty shopping. But at least the “compulsory payment” regulations address the specific problem at hand. More to the point, however, new Section 909 sends a sharp reminder that taxpayers can no longer split tax from income without a serious—and rather broadly enunciated—risk of losing their foreign tax credits.

1

Pritired 1, LLC, 108 AFTR 2d 2011-6605, 2011-2 USTC ¶50654, 816 F Supp 2d 693 (DC Iowa, 2011).

2

The London Interbank Offered Rate, a standardized, published interbank interest rate.

3

AIG , No. 09-cv.-1871 (S.D.N.Y.).

4

AIG Memorandum of Law in support of partial summary judgment; 7/30/10.

5

For example, in 1997 one of the Financing Subsidiaries, Maitengrove, had $13.2 million of taxable income for foreign purposes and paid $4.7 million of Irish corporate tax. Maitengrove's taxable income for U.S. purposes on the other hand, was $5.4 million.

6

Hewlett-Packard, No.021976-07 (TC). For a similar case involving AIG, see *supra* note 2.

7

In 1997, because the contingent interest was not included in income for U.S. purposes, NAC's income was approximately $9 million but it got credit for approximately $27 million of tax paid to the Netherlands.

8

Sovereign Bancorp Inc., No. 1:09-cv-11043-GAO (DC Mass., 2009). For similar cases involving other taxpayers, see Bank of New York Mellon Corp., No. 0266683-09 (TC); Wells Fargo & Co., No. 09-2764 (DC Minn); Santander Holdings, No. 1:09-cv-11043-GAO (DC Mass); Salem Financial, No. 1:10-cv-00192-TCW (Ct. Fed. Cl.).

9

Sovereign Bank complaint dated 6/9/09; Case: No. 1:09-cv-11043-GAO.

10

KPMG memo to Sovereign Bank board on UK tax consequences of STARS transaction, dated 12/21/04.

11

Barclays Project STARS Extension presentation to Sovereign Bank dated 10/18/04; Case 1:09-cv-11043-GAO Document 60-9 filed 3/4/11.

12

TD 9121, 4/20/04, 69 Fed. Reg. 21405.

13

TD 9292, 10/19/06, 71 Fed. Reg. 6164.

14

Fed. Reg. Vol. 72, No. 61, p. 15081.

15

TD 9535; TD 9536, 7/18/11.

16

Reg. 1.901-2(a)(1)(ii).

17

Reg. 1.901-2(a)(2)(i).

18

Reg. 1.901-2(e)(5)(i).

19

Reg. 1.901-2(f).

20

Notice of Proposed Rulemaking,. Fed. Reg. Vol. 71, No. 150, p. 44240.

21

Guardian Industries Corp., 95 AFTR 2d 2005-1692, 65 Fed Cl 50, 2005-1 USTC ¶50263 (Fed. Cl. Ct., 3/31/05) affd. 99 AFTR 2d 2007-1163, 477 F3d 1368, 2007-1 USTC ¶50281 (CA-F.C., 2007), See also Andersen, Richard; *Foreign Tax Credits* (Warren, Gorham & Lamont, 1996), Chap. 2.02(3)(f).

22

TD 9576, 2/8/12, Fed. Reg. Vol. 77, No. 30, 8120.

23

Reg. 1.901-2(f).

24

Fed. Reg. Vol. 77, No. 30, 8127, 2/9/12.

25

The Treasury Department and IRS had previously issued Notice 2010-92, 2010-52 IRB 916, which addressed the application of Section 909 to foreign income taxes paid or accrued by a Section 902 corporation in pre-2011 tax years. The temporary regulations effectively provide that Notice 2010-92 will govern the application of Section 909 to foreign income taxes paid or accrued in a tax year beginning on or after 1/1/11 and before 1/1/12.

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Notice 94-47, 1994-1 CB 357; TIFD III-E, Inc., 98 AFTR 2d 2006-5616, 459 F3d 220, 2006-2 USTC ¶50442 (CA-2, 2006); J.S. Biritz Constr. Co., 20 AFTR 2d 5891, 387 F2d 451, 68-1 USTC ¶9118 (CA-8, 1967); In Matter of Uneco, Inc., 37 AFTR 2d 76-1119, 532 F2d 1204, 76-1 USTC ¶9326 (CA-8, 1976).

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AIG , No. 09-cv-1871 (Dc N.Y.). IRS reply brief against summary judgment.

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Letter to Judge Stanton, dated 9/23/09.

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See citations *supra* note 8.

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Reg. 1.881-3.

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Del Commercial Properties, Inc., 87 AFTR 2d 2001-2451, 251 F3d 210, 2001-2 USTC ¶50474 (CA-D.C., 2001).