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PRACTITIONERS' CORNER

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The IRS has taken a step toward vigorous — aggressive even, some might say — enforcement of the compulsory payment rule for foreign tax credits. In CCA 200920051, the IRS suggests that an Italian election to treat two entities as transparent for Italian tax purposes resulted in a noncompulsory (therefore noncreditable in the United States) foreign tax payment.

The compulsory payment rule (also called the noncompulsory or voluntary payment rule) essentially provides that taxpayers must make all reasonable efforts to reduce their foreign taxes, over time, to the maximum extent possible.[1] If an election or option under foreign law merely shifts a foreign tax liability to a different year or years, choosing or failing to choose it does not make a tax noncompulsory. (The IRS has distinguished situations in which an election instead changes the amount, rather than merely the year. See FSA 200049010.) Lastly, a taxpayer is not required to change ''its form of doing business, its business conduct, or the form of any business transaction'' in order to comply with the compulsory payment rule. [Treas. reg. section 1.904-2(e)(5).]

In a recent chief counsel advice (CCA), the IRS suggests using the compulsory payment rule in a somewhat unusual way, to address moving foreign taxes to a different taxpayer (and thus separating the U.S. foreign tax credit from U.S. recognition of the associated foreign income) rather than an actual aggregate increase in the foreign tax. CCA 200920051 involves a U.S. taxpayer who owns two Italian controlled foreign corporations (A and B, or Italian disregarded entities (DEs)) and checks the box to disregard them for U.S. purposes. The taxpayer then contributes its interests in two other CFCs (C and D, or lowest-level CFCs) pro rata to A and B. The lowest-level CFCs elect to be treated as flow-through entities under Italian law, for Italian tax purposes. This election requires the consent of all of C and D's shareholders.

The lowest-level CFCs earn income that is taxable in Italy. The CCA assumes that such income is not subpart F income.[2] For Italian tax purposes, C and D are treated as flow-through entities, and their income is attributed to A and B. Thus, under Italian law, A and B have both taxable income and legal liability for the associated taxes. U.S. tax law, in contrast, views the income as staying at the C and D level, because it views C and D as corporations. Because A and B are

[1]Treas. reg. section 1.901-2(e)(5); *see also* Treas. reg. section 1.901-2(a)(1) (''A foreign levy is a tax if it requires a compulsory payment . . . '').

[2]If it were, the same technical issues would arise under the compulsory payment rule, but the IRS probably would not see the results as offensive because the taxpayer would both recognize the foreign-source income and claim the associated foreign tax credit. The IRS would therefore be less likely to raise the compulsory payment issue in that circumstance.

disregarded entities under U.S. tax law, the legal liability imposed by Italy on A and B is treated by the United States as falling on the taxpayer. The taxpayer therefore claims a U.S. foreign tax credit under section 901, while the associated income remains in Italy, possibly forever. If the U.S. foreign tax credit were allowed for the Italian taxes, the taxpayer would succeed in separating the foreign tax credit from the related income by attaching the income and taxes to separate but related entities, achieving a result reminiscent of *Guardian Industries*.[3]

In the CCA, the IRS chief counsel suggests that the Italian taxes might be noncreditable because of the compulsory payment rule, since the flow-through election by C and D causes the Italian DEs' (and therefore the taxpayer's) Italian taxes to increase. The IRS notes that A and B's Italian tax liability is ''permanently increased,'' meaning that this is not merely a shift from one year to another. The CCA states that ''arguably'' the U.S. parent makes the election because its consent is required.[4] Treating shareholder consent as constituting the election is a logical leap, which is phrased tentatively in the ruling and is probably unnecessary for the CCA's conclusion. The CCA's result arguably should be the same whether the parent is deemed to make the election or merely consents to it. The IRS could instead argue that the taxpayer's consent (the Italian DEs' consent, treated as the taxpayer's) caused the increase in the taxpayer's Italian tax and should have been withheld.

The IRS rejects the idea that the election is covered by the compulsory payment rule's exception for ''form of doing business.'' It states that the taxpayer chose the business form of CFCs, then made the election. What the IRS does not clearly articulate in this CCA, but seems to be moving toward, is a distinction between elections (and other choices) that have purely tax consequences and those that have nontax, business impacts (other than business benefits obtained by providing beneficial tax consequences to counterparties, for example). The regulations do not require a taxpayer to change its form of doing ''business,'' or ''business'' conduct. The IRS could argue that this really does mean ''business'' items, and does not include any action that has only tax consequences, such as an election to be treated as transparent for foreign tax purposes.

Such an interpretation of the business form exception would be consistent with a previous ruling, TAM 200807015, which states that an election to surrender a loss from one entity to another under U.K. law was not a ''form of doing business,'' even if it was necessary to the transaction and previously agreed to by the parties. The ruling concludes that the U.K. tax resulting from failure to surrender the loss to one U.K.-perceived taxpayer rather than the other was a noncreditable voluntary payment. The IRS also has a recent history of assertively applying the compulsory payment rule to elections in general. For example, CCA 200622044 addressed a situation in which U.K. law allowed a U.K. taxpayer to use its third-country taxes as an offset against either a creditable (for U.S. tax purposes) U.K. tax or a noncreditable U.K. tax. The taxpayer elected to reduce the noncreditable U.K. tax, and the ruling concluded that a portion of the otherwise creditable U.K. tax was therefore a noncompulsory payment. As in CCA 200920051, the election did not affect the aggregate amount of foreign tax paid.[5]

The preceding two rulings and CCA 200920051 state the IRS's position but have not been confirmed by binding IRS authority (in the form of regulations or a revenue ruling, for example) or by a court. The IRS seems to have a solid legal argument, however, for its apparent theory that ''form of doing business . . . business conduct, or the form of any business transaction''[6] does not include actions with only tax effects. It would have a more difficult time pursuing this position regarding any election that produced some nontax consequences. In the future, taxpayers might push back regarding the ratio of nontax effects, compared to tax effects, that is required before an action or election is protected from compulsory payment arguments by the ''business form'' exception. The IRS might conceivably consider a test that seeks ''substantial'' business effects compared to tax effects if it applies a formulation similar to new code section 7701(o) and former Notice 98-5.

If the IRS continues on this road of arguing that elections with only or mostly tax consequences are not protected by the business form exception, one wonders how far they are willing to push this theory. What about an entity's initial choice, on formation, to be treated as one kind of entity (for example, corporation, partnership, or other) rather than another? If that choice has only or mostly tax consequences, and if the form selected is reasonably expected to result in higher

[3]*Guardian Industries v. United States*, 477 F.3d 1368 (Fed. Cir. 2007).

[4]The IRS does not argue, in this CCA, that the U.S. parent should be held responsible for all of the lowest tier CFCs' actions by reason of ownership and control, perhaps because other shareholders also owned sizable interests in C and D. (That fact is not provided in the CCA.) The IRS is not, however, precluded from making that argument in the future.

[5]The interesting part of CCA 200622044 was the IRS's argument that the compulsory payment rule relates to taxpayers' reduction of creditable (in the United States) foreign taxes, not just the aggregate amount of creditable and noncreditable foreign taxes.

[6]Treas. reg. section 1.901-2(e)(5)(i).

foreign tax over time, could the compulsory payment rule apply despite the exception for business structure?

What about other elections that have only tax effects, such as group relief elections under foreign law? Could Guardian Industries' foreign tax credits have been challenged under the compulsory payment rule, on the grounds that the election of group relief under Luxembourg law increased the U.S. parent's Luxembourg taxes (if the taxpayer was correct that legal liability for the group belonged to the group parent)? *Compare* TAM 200807015. (The taxpayer in TAM 200807015 argued that *Guardian Industries* showed that an election that had only tax consequences did not violate the compulsory payment rule. The IRS responded that the issue was not raised in *Guardian Industries*.)

Further, the CCA uses the compulsory payment rule when one would expect the IRS to use another weapon. Normally, as in *Guardian Industries*, questions about the appropriate taxpayer are addressed through the legal liability rule, also known as the technical taxpayer rule.[7] Indeed, the proposed legal liability regulations would address the CCA's fact pattern through a special rule for reverse hybrids: When a foreign country imposes tax on an entity that it sees as a flow-through but that U.S. tax law views as a corporation, the tax is treated as imposed on the combined income of the flow-through and its owner.[8] Under the proposed regulations' combined income rule, the reverse hybrid and its owner effectively are then treated as each having legal liability for the foreign tax on their aggregate income in the same proportions as their respective ownership of the tax base. Under the CCA's fact pattern, the proposed regulations would treat the lowest-level CFCs as having legal liability for the Italian tax imposed on their income, despite Italy's view that C and D are transparent.[9] The taxpayer then would not be able claim a U.S. foreign tax credit for such Italian tax until it received a distribution, subpart F inclusion, or other inclusion from C or D that allowed it to claim a credit under sections 902 or 960. The proposed legal liability regulations, however, are not effective until finalized. Nor are they even mentioned in this CCA, which may or may not signal anything about the government's predictions about their issuance.

Also, the IRS considers using the compulsory payment rule on CCA 200920051's facts even though the taxpayer could avoid that rule in a number of ways. For example, the middle-level entities (A and B) could have been corporations or partnerships, rather than disregarded entities for U.S. purposes. In that case, the 80-percent U.S.-owned foreign group rule, elective under proposed regulations and Notice 2007-95, would likely have applied to protect C and D's election from the compulsory payment rule.[10] The U.S. tax result would not have been as favorable as the CCA-described structure, because some income inclusion at the U.S. level would have been required before credits could be used. But that income inclusion could have been relatively small, compared to C and D's foreign-source income on which the Italian tax was imposed. Similarly, the taxpayer could have interposed a foreign entity between itself and the Italian DEs, and moved credits up to the taxpayer level with a relatively small income inclusion from the new foreign intermediate entity.

Lastly, it appears that the IRS might have been unwilling to make the compulsory payment argument if the taxpayer and the Italian DEs had been neither required to approve the Italian election nor able to make the election for C and D. Foreign laws that do not require shareholder approval for such tax elections (for example, which assume that controlling shareholders must de facto approve all actions of a lower-tier entity) appear to be outside the ruling's articulated rationale. This might result merely from the fact that the IRS did not need to address a no-consent-required fact pattern in this ruling, or it might indicate actual reluctance to assert that majority or 100 percent shareholders are responsible for their corporations's elections (although the ruling does not state the amount of the taxpayer's ownership in the lowest level CFCs).

In summary, CCA 200920051 signals that the IRS is willing to turn to the compulsory payment rule in some surprising situations when it lacks other viable approaches to address the splitting of foreign tax credits from the income on which the foreign taxes are imposed. What presumably bothers the IRS about the CCA's fact pattern is the separation of foreign-source income from the associated foreign tax credits, and the legal liability rule has been the IRS's traditional weapon in such situations. The ruling also continues the IRS's trend of narrowly interpreting the ''business form'' exception. The IRS's willingness to creatively apply the compulsory payment rule is notable, among other reasons, because noncompulsory payment results in noncreditability, which is a harsh result compared to other rules that may merely defer credit availability or leave open the possibility that another taxpayer can claim credits for the relevant taxes. ◆

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[7]*See* Treas. reg. section 1.901-2(f)(1).

[8]Prop. Treas. reg. section 1.901-2(f)(2)(iii).

[9]The proposed regulations would treat the disregarded CFCs as persons for purposes of the combined income rule, and then any legal liability of such disregarded entities would be attributed to their owner. *See* prop. Treas. reg. section 1.901-2(f)(2).

[10]*See* prop. Treas. reg. section 1.901-2(e)(5)(iii), Notice 2007-95, CCA 200920051 (suggesting that the group rule could apply if A and B were not disregarded entities).