Notice 98-5, 1998-1CB 334--IRC Sec(s). 42

December 23, 1997

Treasury and the Internal Revenue Service understand that certain U.S. taxpayers (primarily multinational corporations) have entered into or may be considering a variety of abusive tax- motivated transactions with a purpose of acquiring or generating foreign tax credits that can be used to shelter low-taxed foreign- source income from residual U.S. tax. These transactions generally are structured to yield little or no economic profit relative to the expected U.S. tax benefits, and typically involve either: (1) the acquisition of an asset that generates an income stream subject to foreign withholding tax, or (2) effective duplication of tax benefits through the use of certain structures designed to exploit inconsistencies between U.S. and foreign tax laws. This notice announces that Treasury and the Service will address these transactions through the issuance of regulations as well as by application of other principles of existing law, and requests public comment with respect to these and related foreign tax credit issues.

I. Background

United States persons are subject to U.S. income tax on foreign-source as well as U.S.-source income. Subject to applicable limitations, U.S. persons with foreign-source income may credit income taxes imposed by foreign jurisdictions against their U.S. income tax liability on foreign-source income.

Worldwide taxation of U.S. persons coupled with the allowance of a foreign tax credit establishes general tax neutrality between foreign and domestic investment by U.S. taxpayers. A tax system that simply exempts foreign-source income from taxation creates an incentive for citizens and residents to invest overseas in low-taxed jurisdictions. On the other hand, worldwide taxation without a foreign tax credit creates double taxation that distorts investment decisions by inhibiting foreign investment or business activities. The foreign tax credit provisions of the Code, principally sections 901 through 907 and 960, effectuate Congress's intent to provide relief from double taxation and alleviate these distortions. American Chicle Co. v. United States, 316 U.S. 450 [29 AFTR 193] (1942); Burnet v. Chicago Portrait Co., 285 U.S. 1 [10 AFTR 800] (1932).

In contrast to certain tax credits that are intended to create an incentive for taxpayers to invest in certain activities, such as the research credit under section 41 or the low-income housing credit under section 42, the foreign tax credit is designed to reduce the disincentive for taxpayers to invest abroad that would be caused by double taxation. In other words, the foreign tax credit is intended to preserve neutrality between U.S. and foreign investment and to minimize the effect of tax consequences on taxpayers' decisions about where to invest and conduct business.

Relief from double taxation generally is not calculated separately with respect to each dollar of foreign-source income and tax. The foreign tax credit limitation or "basket" regime of section 904(d) permits, to a limited extent, a credit for foreign tax imposed with respect to income taxed at a rate in excess of the applicable U.S. rate to shelter from U.S. tax income from other, similar investments and activities that are subject to a relatively low rate of tax (the "cross-crediting regime"). Accordingly, the foreign tax credit provisions do not limit credits on an item-by-item basis. Rather, subject to certain restrictions, the provisions permit cross- crediting of foreign taxes imposed with respect to specified groups or types of income as consistent with the interrelated quality of multinational operations of U.S. persons.

Multinational corporations that are subject to relatively low rates of tax on their foreign-source income may be in an excess limitation position. Generally, such taxpayers may properly use credits for foreign taxes imposed on high-taxed foreign income to offset residual U.S. tax on their low-taxed foreign income.

Treasury and the Service are concerned, however, that such taxpayers may enter into foreign tax credit-generating schemes designed to abuse the cross-crediting regime and effectively transform the U.S. worldwide system of taxation into a system exempting foreign-source income from residual U.S. tax.

This result is clearly incompatible with the existence of the detailed foreign tax credit provisions and cross-crediting limitations enacted by Congress. No statutory purpose is served by permitting credits for taxes generated in abusive transactions designed to reduce residual U.S. tax on low-taxed foreign-source income. The foreign tax credit benefits derived from such transactions represent subsidies from the U.S. Treasury to taxpayers that operate and earn income in low-tax or zero-tax jurisdictions. The effect is economically equivalent to the tax sparing benefits for U.S. taxpayers that Congress and the Treasury have consistently opposed in the tax treaty context because such benefits are inconsistent with U.S. tax principles and sound tax policy.

II. Abusive Arrangements

Treasury and the Service have identified two classes of transactions that create potential for foreign tax credit abuse. The first class consists of transactions involving transfers of tax liability through the acquisition of an asset that generates an income stream subject to foreign gross basis taxes such as withholding taxes. Transactions described in this class may include acquisitions of income streams through securities loans and similar arrangements and acquisitions in combination with total return swaps. In abusive arrangements involving such transactions, foreign tax credits are effectively purchased by a U.S. taxpayer in an arrangement where the expected economic profit from the arrangement is insubstantial compared to the foreign tax credits generated.

The second class of transactions consists of cross-border tax arbitrage transactions that permit effective duplication of tax benefits. Duplicate benefits result when the U.S. grants benefits and, in addition, a foreign country grants benefits (including benefits from a full or partial imputation or exemption system, or a preferential rate for certain income) to separate persons with respect to the same taxes or income. These duplicate benefits generally can result where the U.S. and a foreign country treat all or part of a transaction or amount differently under their respective tax systems. In abusive arrangements involving such transactions, the U.S. taxpayer exploits these inconsistencies where the expected economic profit is insubstantial compared to the foreign tax credits generated.

The following are examples of abusive arrangements within the scope of this notice.

Example 1

On June 29, 1998, US, a domestic corporation, purchases all rights to a copyright for $75.00. The copyright will expire shortly and the only income expected to be received with respect to the copyright is a royalty payable June 30, 1998. The gross amount of the royalty is expected to be $100.00. The royalty payment is subject to a 30-percent Country X withholding tax. On June 30, 1998, US receives the $100.00 royalty payment, less the $30.00 withholding tax. US reasonably expects to incur a $5.00 economic loss (having paid $75.00 for the right to receive a $70.00 net royalty payment), but expects to acquire a $30.00 foreign tax liability. In this example, US has effectively purchased foreign tax credits in a transaction that was reasonably expected to result in an economic loss.

Example 2

On June 29, 1998, US, a domestic corporation, purchases a foreign bond for $1096.00 (including accrued interest). The foreign bond provides for annual interest payments of $100.00 payable June 30 of each year. The interest payments are subject to a 4.9-percent Country X withholding tax. On June 30, 1998, US receives a $95.10 interest payment on the bond (net of a $4.90 Country X withholding tax). On July 4, 1998, US sells the bond for $1001.05. Because the value of the bond is not reasonably expected to appreciate due to market factors, US reasonably can expect only a $0.15 economic profit (the $1001.05 sales price and the $95.10 net interest coupon, less the $1096.00 purchase price) and expects to acquire a $4.90 foreign tax liability. In this example, US has effectively purchased foreign tax credits in a transaction with respect to which the reasonably expected economic profit is insubstantial in relation to expected U.S. foreign tax credits. No implication is intended as to whether the interest described in this example will constitute high withholding tax interest under section 904(d)(2)(B).

Example 3

F, an entity that does not receive a tax benefit from foreign tax credits, wishes to acquire a foreign bond with a value of $1000.00 that provides for annual interest payments of $100.00. The interest payments are subject to a 4.9-percent Country X withholding tax. Instead of purchasing the bond, F invests its $1000.00 elsewhere and enters into a three-year notional principal contract (NPC) with US, an unrelated domestic corporation. Under the terms of the NPC, US agrees to make an annual payment to F equal to $96.00 and F agrees to make an annual payment to US equal to the product of $1000.00 and a rate calculated based on LIBOR. In addition, the parties agree that, upon termination of the NPC, US will make a payment to F based on the appreciation, if any, in the value of the foreign bond, and F will make a payment to US based on the depreciation, if any, in the value of the foreign bond. In order to hedge its obligations under the NPC, US purchases the bond for $1000.00. Assume that, in connection with the purchase of the foreign bond, US incurs or maintains an additional $1000.00 of borrowing at an interest rate equal to the LIBOR-based rate provided for in the NPC.

At the time US enters into this arrangement, US reasonably expects to incur an annual $0.90 economic loss each year under the arrangement (the $95.10 net interest payment on the bond plus the LIBOR-based amount received from F under the NPC, less the sum of the $96.00 payment to F under the NPC and the LIBOR-based amount associated with the $1000.00 borrowing incurred or maintained in order to acquire the foreign bond). In this example, US has effectively purchased foreign tax credits in a transaction that was reasonably expected to result in an economic loss.

Example 4

US, a domestic corporation, forms N, a Country X corporation, by contributing $10.00 to the capital of N in exchange for the only share of N common stock. N borrows $90.00 from F, a Country X individual unrelated to US, at an annual interest rate of 7.5 percent, and N purchases preferred stock of an unrelated party with a par value of $100.00 or a bond with a face amount of $100.00. US reasonably expects the preferred stock or bond to pay dividends or interest at an annual rate of 10 percent. Alternatively, rather than purchasing preferred stock or the bond, N lends $100.00 to US at an annual interest rate of 10 percent.

Country X treats the F loan as an equity investment and does not allow a deduction for N's interest expense. Country X imposes an individual income tax and a corporate income tax of 30 percent. Country X thus is expected to impose a $3.00 corporate income tax each year on N. Country X has an imputation system, under which dividends from Country X corporations are excluded from the gross income of Country X individuals. (A similar result could be achieved if the dividends are wholly or partially exempt from Country X tax due to a consolidated return or group relief regime, a dividend-received deduction, or an imputation credit.)

At the time US enters into this arrangement, US reasonably expects that N will have annual earnings and profits of $0.25 ($10.00 dividend or interest income from the preferred stock or bond (or $10.00 interest income from the loan to US), less $6.75 interest expense and $3.00 foreign tax liability). US expects that each year N will pay a $0.25 dividend to US and US will claim a $3.00 foreign tax credit for taxes deemed paid under section 902. In this example, US has entered into an arrangement to exploit the inconsistency between U.S. and Country X tax laws in order to generate foreign tax credits in a transaction with respect to which the reasonably expected economic profit is insubstantial in relation to expected U.S. foreign tax credits.

Example 5

US, a domestic corporation, forms N, a Country X entity. US contributes $100.00 to the capital of N in exchange for a 100- percent ownership interest. N borrows $900.00 from F, an unrelated Country X corporation, at an annual interest rate of 8 percent, and N purchases preferred stock of an unrelated party with a par value of $1000.00 that US reasonably expects to pay dividends at an annual rate of 10 percent. The dividends are subject to a Country Y 25- percent withholding tax.

Country X treats the F loan as an equity investment in N and treats N as a partnership. Consequently, F claims a foreign tax credit in Country X for 90 percent of the withholding tax paid by N. Under U.S. law, the F loan is respected as debt, and N is disregarded as a separate entity (a partnership with only one partner). See Reg. section 301.7701-3(a) and section 301.7701-3(b)(2)(C). Thus, US claims a U.S. foreign tax credit for the taxes paid by N and the tax benefit of the foreign taxes paid by N are effectively duplicated.

At the time US enters into this arrangement, US reasonably expects an annual profit of $3.00 ($100.00 dividend income, less $72.00 interest expense and $25.00 foreign tax liability) and an annual foreign tax credit of $25. In this example, US has entered into an arrangement to exploit the inconsistency between U.S. and Country X tax laws in order to generate foreign tax credits in a transaction with respect to which the reasonably expected economic profit is insubstantial in relation to expected U.S. foreign tax credits.

III. Regulations to be Issued Pursuant to this Notice

Regulations will be issued to disallow foreign tax credits for taxes generated in abusive arrangements such as those described in Part II above. These regulations will be issued under the authority of some or all of the following sections of the Internal Revenue Code of 1986: section 901, section 901(k)(4), section 904, section 864(e)(7), section 7701(l), and section 7805(a).

In general, these regulations will disallow foreign tax credits in an arrangement such as those described in Part II above from which the reasonably expected economic profit is insubstantial compared to the value of the foreign tax credits expected to be obtained as a result of the arrangement. The regulations will emphasize an objective approach to calculating expected economic profit and credits, and will require that the determination of expected economic profit reflect the likelihood of realizing both potential gain and potential loss (including loss in excess of the taxpayer's investment). Thus, under the regulations, expected economic profit will be determined without regard to executory financial contracts (e.g., a notional principal contract, forward contract, or similar instrument) that do not represent a real economic investment or potential for profit or that are not properly treated as part of the arrangement. Further, the regulations will require that expected economic profit be determined over the term of the arrangement, properly discounted to present value.

It is expected that the regulations in general and any test relying on a comparison of economic profit and credits in particular would be applied to discrete arrangements. The utility of a test comparing profits and credits depends upon the proper delineation of the arrangement to be tested. If necessary to effectuate the purposes of the regulations, a series of related transactions or investments may be treated as a single arrangement or portions of a single transaction or investment may be treated as separate arrangements. The proper grouping of transactions and investments into arrangements will depend on all relevant facts and circumstances.

For example, a series of transactions involving a purchase and resale might be treated as a single arrangement. Similarly, an investment together with related hedging and financing transactions, e.g., a borrowing, an investment, and an asset swap designed to limit the taxpayer's economic exposure with respect to the investment, might be treated as a single arrangement. In addition, if a controlled foreign corporation, as part of its business, enters into a buy-sell transaction involving a debt instrument, that buy-sell transaction could be treated as a separate arrangement.

In general, reasonably expected economic profit will be determined by taking into account foreign tax consequences (but not U.S. tax consequences). However, it is inappropriate in the context of the U.S. foreign tax credit system to allow foreign tax credits with respect to abusive arrangements simply because the arrangements generate substantial foreign tax savings. Accordingly, the regulations will provide that the calculation of expected economic profit will not include expected foreign tax savings attributable to a tax credit or similar benefit allowed by a foreign country with respect to a tax paid to another foreign country.

In general, expected economic profit will be determined by taking into account expenses associated with an arrangement, without regard to whether such expenses are deductible in determining taxable income. For example, in determining economic profit, foreign taxes will be treated as an expense. In addition, interest expense (and similar amounts, including borrowing fees, "in lieu of" payments, forward contract payments, and notional principal contract payments) generally will be taken into account in determining expected economic profit only to the extent that the indebtedness or contract giving rise to the expense is part of the arrangement.

In addition, the regulations will provide special rules that will operate to deny credits for foreign taxes generated in abusive arrangements involving asset swaps or other hedging devices (including rules that allocate interest expense to an arrangement in certain cases other than pursuant to a tracing approach). For example, an arrangement involving a purchase of a foreign security coupled with an asset swap that is designed to hedge substantially all of the taxpayer's risk of loss with respect to the security for the duration of the arrangement generally will constitute an abusive foreign tax credit arrangement even if the taxpayer has not incurred indebtedness for the specific purpose of acquiring the asset. However, the regulations will not treat arrangements involving debt instruments as abusive solely because the taxpayer diminishes its risk of interest rate or currency fluctuations, unless the taxpayer also diminishes its risk of loss with respect to other risks (e.g., creditor risk) for a significant portion of the taxpayer's holding period. See Part VI of this notice for additional rules for portfolio hedging strategies and partial hedges.

Under the foregoing principles, the regulations will not disallow foreign tax credits merely because income from the arrangement is subject to a high foreign tax rate. Treasury and the Service anticipate that credits for taxes paid to a high-tax jurisdiction will not be subject to disallowance under the regulations absent other indicia of abuse.

The regulations generally will not disallow a credit for withholding taxes on dividends if the holding period requirement of section 901(k) is satisfied. However, the regulations will operate to determine whether foreign tax credits with respect to cross-border tax arbitrage arrangements (as described in Part II, above) will be disallowed, even if such credits arise with respect to withholding taxes on dividends and the section 901(k) holding period is satisfied. In addition, the regulations generally will apply to determine whether credits should be disallowed with respect to qualified taxes (as defined in section 901(k)(4)(B)) that are not subject to the general section 901(k) holding period rule. For example, the regulations may disallow credits with respect to gross basis taxes paid or accrued with respect to certain arrangements involving equity swaps and equity buy-sell transactions entered into by securities dealers even if such credits would not have been disallowed under section 901(k) pursuant to section 901(k)(4). See section 901(k)(4)(C).

IV. Effective Date of Regulations Issued Pursuant to this Notice

The regulations to be issued with respect to arrangements of the kind described in Part II above generally will be effective with respect to taxes paid or accrued on or after December 23, 1997, the date this notice was issued to the public. The effective date of the regulations issued pursuant to this notice, however, will not limit the application of other principles of existing law to determine the proper tax consequences of the structures or transactions addressed in the regulations.

V. IRS Coordination Procedures

The Service intends to carefully examine foreign tax credits claimed in arrangements of the type described in Part II to determine whether such credits should be disallowed under existing law even without application of the regulations to be issued pursuant to this notice. The Service plans to establish early coordination procedures utilizing foreign tax credit experts in the National Office and the International Field Assistance Specialization Program to assist examining agents in analyzing these transactions. These coordination procedures will continue in effect following issuance of the regulations to ensure uniform and appropriate application of the regulations by examining agents.

VI. Other Foreign Tax Credit Guidance

Treasury and the Service are considering issuing other guidance to ensure that foreign tax credits are allowed to U.S. taxpayers in a manner consistent with the overall structure of the Code and the intent of Congress in enacting the credit.

For example, Treasury and the Service are considering issuing additional regulations under section 904(d)(2)(B)(iii) to address abusive transactions involving high withholding taxes. Treasury and the Service are also considering whether additional approaches may be necessary to identify abuses in the case of foreign gross basis taxes generally.

In addition, Treasury and the Service are considering various approaches to address structures (including hybrid entity structures) and transactions intended to create a significant mismatch between the time foreign taxes are paid or accrued and the time the foreign-source income giving rise to the relevant foreign tax liability is recognized for U.S. tax purposes. For such structures and transactions, Treasury and the Service are considering either deferring the tax credits until the taxpayer recognizes the income, or accelerating the income recognition to the time at which the credits are allowed (e.g., by allocating the credits or the income under section 482).

Finally, Treasury and the Service are concerned about credits claimed in transactions described in Part II above, with respect to assets or income streams that are hedged pursuant to portfolio hedging strategies and with respect to hedges entered into with respect to assets or income streams that the taxpayer holds without diminished risk of loss for a significant period of time.

In general, regulations addressing these other foreign tax credit issues will be effective no earlier than the date on which proposed regulations (or other guidance such as a notice) describing the tax consequences of the arrangements are issued to the public. The effective date of any such regulations will not, however, affect the application of other principles of existing law to determine the proper tax consequences of the structures or transactions addressed in the regulations.

VII. Comments

Comments are requested on the matters discussed in this notice. Written comments may be submitted to the Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attention: CC:DOM:CORP:R (Notice 98-5), Room 5226, Washington DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 98-5), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington DC. Alternatively, taxpayers may submit comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. Comments will be available for public inspection and copying.

For further information regarding this notice, contact Seth Goldstein or Rebecca Rosenberg of the Office of Associate Chief Counsel (International) at 202-622-3850 (not a toll-free call).