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The Foreign Tax Credit War

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The government has been involved in a sustained war against objectionable foreign tax credit transactions. This war has caused the U.S. foreign tax credit regime to be riddled with complexity that spawns incoherent outcomes. The complexity contained in section 901 was created due to a legitimate concern: the threats posed by objectionable transactions that artificially generate excess foreign tax credits represent real policy problems. Since at least 1975, Congress and the Treasury Department have been convinced that the cross-crediting of excess foreign tax credits arising from "objectionable transactions" required a response in addition to simply relying on section 904. Thus, it is understandable that Congress and the Treasury Department would seek to redefine the foreign tax credit eligibility standards in response to transactions that generate foreign tax credits in objectionable ways. However, the historical record indicates that Congress and the Treasury Department ran roughshod over section 901 and used a scorched earth approach in their war against objectionable foreign tax credit transactions. The result is that the U.S. foreign tax credit regime is a "byzantine structure of staggering complexity."[1] *In the rush to enact reforms, ill-conceived provisions were enacted that should not have been enacted.*

Objectionable foreign tax credit transactions needed principled responses, and principled responses were enacted in the midst of a scattergun attack on these objectionable transactions. However, the United States must have a principled foreign tax credit regime that

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1. *See infra* note 24.

balances the need to prevent international double income taxation with the need to prevent abusive transactions. This Article addresses the disallowance provisions that have been added to section 901 as part of the government's war against objectionable foreign tax credit transactions and assesses which of those provisions serve a continuing policy objective and which do not. This Article argues that U.S. tax law would be greatly improved if section 901 embodied a principled approach and if redundant provisions that create incoherent outcomes were removed.

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I. INTRODUCTION

The government has waged a sustained war against objectionable foreign tax credit transactions.[2] The impacts of these hostilities have caused the U.S. foreign tax credit regime to be riddled with enormous complexity. It is now time to take a step back and reconsider the fundamental interest that a foreign tax credit regime seeks to promote and the fundamental interest that the U.S. government has in preventing cross-crediting of excess foreign tax credits generated from objectionable transactions. This inquiry is needed so that the U.S. foreign tax credit regime can be made more coherent.

As an initial matter, it is important to note that the U.S. foreign tax credit regime has grown in importance due to the policy choices of other developed nations. In the formative debates about international tax policy, tax scholars predicted that all nations would adopt worldwide income tax regimes as they moved from semi-developed status to developed nation status.[3] But, in fact, the world has moved in the opposite direction, with most of the major U.S. trading partners adopting territorial tax regimes.[4] A territorial tax regime does not impose meaningful taxation over extra-territorial profits, and so international double income taxation is structurally avoided with such a regime.[5] Consequently, the continued adherence by the United States to a worldwide income tax regime represents an increasingly divergent tax system with important implications for the

2. The term "foreign tax credit generator" is of recent vintage. *See* I.R. 2007-73, IRS Issues Regulations on Transactions Designed to Artificially Generate Foreign Tax Credits (Mar. 29, 2007) (using the term "foreign tax credit generator transactions") But, as will be demonstrated in this Article, the policy motivations that engender hostility to artificial generation of foreign tax credits has represented a significant force in the evolution of existing law for at least forty years.

3. League of Nations Econ. & Fiscal Comm., *Report on Double Taxation to the Financial Committee of the League of Nations*, League of Nations Doc. E.F.S. 73 F. 19 at 51 (1923).

4. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, 112th Cong., BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME, JCX-33-11 (2011) (analyzing nine major U.S. trading partners that provide for an exemption system); *see also* Staff of the Joint Committee on Taxation, *Present Law and Issues in U.S. Taxation of Cross-Border Income*, JCX-42-11 (2011) (reviewing policy considerations between a territorial and worldwide tax system).

5. *See supra* note 4.

U.S. foreign tax credit regime. Multinational enterprises located in territorial tax regimes have no meaningful risk of international double income taxation. In contrast, U.S. multinational enterprises must rely on a coherently functioning U.S. foreign tax credit regime to avoid international double income taxation.[6] Respected scholars have forcefully argued that worldwide taxation of resident multinational enterprises is the best policy choice for our country,[7]

6. Professor Kingson succinctly made this point in 1981 as follows:

> The United States uses the credit method, under which a residence country taxes foreign income but reduces its tax by taxes paid to the source country. . . . On the other hand, continental European countries generally use the exemption method, which exempts from corporate tax dividends or branch profits in respect of direct investment abroad. In that case, regardless of the source country tax rate, the residence country has no revenue interst in the investment. By reason of that difference, the residence conflict [with source country taxation] for Germany and other exemption method countries is not complicated, as it is in the United States . . . .

Charles I. Kingson, *The Coherence of International Taxation,* 81 COLUM. L. REV. 1151, 1164–65 (1981).

7. *See e.g.*, J. Clifton Fleming, Jr., Robert J. Peroni & Stephen Shay, *Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig?*, 36 MICH. J. INT'L L. 1, 8 (2014); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen Shay, *Designing a U.S. Exemption System for Foreign Income When the Treasury is Empty,* 13 FLA. TAX REV. 397, 406–12 (2012); Martin J. McMahon, Jr., *Understanding Consolidated Returns*, 12 FLA. TAX REV. 125, 182 (2012); Jasper L. Cummings, Jr., *Consolidating Foreign Subsidiaries,* 11 FLA L. REV. 143, 195–96 (2011); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen Shay, *Reinvegiorating Tax Expenditure Analysis and Its International Dimensions,* 27 Va. Tax Rev. 437, 528–61 (2008); Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 31 TAX NOTES INT'L 1177, 1207 (2003); Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of US Tax On Foreign Source Income*, 52 SMU L. REV. 455, 458 (1999); Reuven S. Avi-Yonah, *To End Deferral as We Know It: Simplification Potential of Check- the-Box*, 74 TAX NOTES 219, 224 (1997); Asim Bhansali, *Globalizing Consolidated Taxation of United States Multinationals*, 74 TEX. L. REV. 1401, 1422 (1996); Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 TAX NOTES 581 (1990); Jane G. Gravelle, *Foreign Tax Provisions of the American Jobs Act of 1996*, 72 TAX NOTES 1165 (1996); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 75 (1993); John McDonald, Comment, *Anti-Deferral Deferred: A Proposal for the Reform of International Tax Law*, 16 NW. J. INT'L L. & BUS. 248, 281 (1995); Peter Merrill & Carol Dunahoo, '*Runaway Plant' Legislation: Rhetoric and Reality*, 72 TAX NOTES 221, 221 (1996); Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 TAXES 1042, 1061 (1996); Joseph Isenbergh, *Perspectives on the Deferral of U.S. Taxation of the Earnings of Foreign Corporations*, 66 TAXES 1062, 1063 (1988); Lee Sheppard, *Last Corporate Taxpayer Out the Door, Please Turn Out the Lights*, 82 TAX NOTES 941, 944 (1999).

and this discussion has generated a spirited rebuttal by other respected scholars.[8]

Instead of joining that larger debate, this Article assumes that the United States will continue to assert residency-based worldwide taxation (either on a current or deferred basis) on the foreign income of U.S. multinational enterprises. In this context, what should the U.S. foreign tax credit regime look like? Even though this Article assumes that residency-based worldwide taxation remains a fixture of U.S. international tax policy for the foreseeable future, the fact that most other countries have opted for a territorial tax regime provides an important backdrop for evaluating the U.S. foreign tax credit regime. Said differently, now that the major trading partners of the United States do not assert meaningful extra-territorial taxation over active foreign business income, the United States simply must have a "coherent"[9] U.S. foreign tax credit regime that does not create unnecessary instances of international double income taxation.[10] But when is international double income taxation

8. Mihir A. Desai, C. Gritz Foley & James R. Hines, Jr., *Domestic Effects of the Foreign Activities of U.S. Multinationals*, 1 AM. ECON. J.: ECON. POLICY 181, 201 (2009); Mihir A. Desai & James R. Hines Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 NAT'L TAX J. 937 (2004); James R. Hines Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (2003); James R. Hines, Jr., *The Case Against Deferral: A Deferential Reconsideration*, 52 NAT'L TAX J. 385, 401–02 (1999); Nat'l Foreign Trade Council, Inc., *The NFTC Foreign Income Project: International Tax Policy for the 21st Century: Part One: A Reconsideration of Subpart F*, 1999 TNT 58-17, [9], [57], Doc. 1999-11623 (1999); Reuven S. Avi-Yonah, *Competition & Competitiveness: Review of NFTC Subpart F Report*, 83 TAX NOTES 582, 582 (1999); Peter R. Merrill, *A Response to Professor Avi-Yonah on Subpart F*, 83 TAX NOTES 1802, 1802 (1999).

9. *See* Charles I. Kingson, *The Coherence of International Taxation,* 81 COLUM. L. REV. 1153 (1981) ("Coherence means, then, that each country must take into account how the others tax international income. . . . [O]ne tax system can take advantage of another; and other countries are taking that advantage of the United States. Their overtaxation limits our revenues; their undertaxation mocks our treaties; and their discrimination, by both law and unequal tax administration, blunts our competitiveness. Unfortunately, the responsibility does not rest entirely abroad. Precisely because tax systems do interact, United States tax decisions have helped create the current situation.").

10. *See* JOINT COMM. ON TAXATION, 99th Cong., *General Explanation of the Tax Reform Act of 1986* at 861 (Comm. Print 1986) ("The purpose of the foreign tax credit is to reduce international double taxation."). But, even though the majority view has been clear about the need for and purpose of the U.S. foreign tax credit, there has been an ongoing debate since at least 1934 about whether the allowance of a tax credit is necessary as the following representative excerpt so indicates:

> Under the Revenue Acts of 1913, 1916, and 1917 a taxpayer was not entitled to any credit for taxes paid to a foreign country. These early acts permitted taxes paid

"necessary" and when is it "inappropriate?" Greater focus and urgency should be brought to bear on this question because the United States must have a coherent foreign tax credit regime given the policy choices of other nations.

The original intent of the U.S. foreign tax credit regime is not hard to understand. In order to mitigate against the perceived evils of international double income taxation, section 901(b)(1) has existed since 1918[11] and provides U.S. foreign tax credit relief for any income and excess profits[12] taxes paid or accrued to a foreign

> to a foreign country to be deducted only from gross income, which was also the rule applied in the case of State, county, and municipal taxes.
>
> Our subcommittee recommended the elimination of the foreign tax credit and a return to the deduction system permitted under the early revenue acts, which system, of course, returns substantially greater revenue than the present method. The Treasury Department, however, was of the opinion that the present method was fair and should be continued, pointing out that "the United States, to avoid burdensome double taxation and to encourage foreign trade, should therefore allow an offsetting credit against its own income tax."

See J. S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS at 373 (1938). Regardless of its origin, the allowance of a foreign tax credit in lieu of a deduction continues to be debated by scholars to this day. *Compare* Daniel N. Shaviro, *The Case Against Foreign Tax Credits*, 3 J. LEGAL ANALYSIS 65 (2011); Kimberly Clausing and Daniel N. Shaviro, *A Burden-Neutral Shift from Foreign Tax Creditability to Deductibility?*, 64 TAX L. REV. 431 (2011), *with* Reuven Avi-Yonah, *No Country is an Island: Is a Radical Rethinking of International Taxation Needed?*, UNIV. OF MICH. L. SCH., U of Michigan Public Law Research Paper No. 380 (2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2389979. Notwithstanding this academic debate, no serious legislative effort has occurred since 1934 to change the creditability of foreign income taxes, thus making the desire to avoid double international income taxation one of the longest and most fundamental aspects of the U.S. international tax regime.

11. *See* REVENUE ACT OF 1918, PUB. L. 65-254, §222(A), 40 STAT. 1057, 1073 (as codified in I.R.C. §901(b)). Initially, the U.S. provided no foreign tax credit relief under the income tax laws of 1909 and 1913. *See generally* REVENUE ACT OF 1909, CH. 6, 36 STAT. 11; REVENUE ACT OF 1913, CH. 16, 38 STAT. 114, at 172. But, the income tax rates were admittedly small, so the cost of not providing U.S. foreign tax credit relief at that time was not significant. However, with the advent of World War I, tax rates increased sharply in the U.S. and other countries. Stanley S. Surrey, *The United States Taxation of Foreign Income*, 1 J.L. & ECON. 72, 73 n.3 (1959). With increasing tax rates in both foreign countries and the United States, the cost of international double taxation became a significant cost to U.S. taxpayers. *Id.* at 73. As a result, in 1918, Congress adopted a foreign tax credit regime. The creation of a broad-based foreign tax credit was principally the invention of Thomas S. Adams, an economic advisor to the Treasury Department at the time. *See* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1038–39 n.71 (1997).

12. Excess profits taxes were imposed on only a portion of total income in excess of a given rate of return. *See* W.G. McAdoo, *Treasury Secretary, Income, Excess Profits, and Estate Taxes: Hearings Before the House Comm. on Ways and Means* 15 (1918) ("By an excess-profits

country. As one of the longest-held U.S. international tax principles, Congress and the judiciary have recognized for almost a century that a robust U.S. foreign tax credit regime is an important feature of U.S. tax law whose fundamental purpose is to prevent international double income taxation.[13] In deciding which foreign taxes represent income and excess profits taxes eligible for U.S. foreign tax credit relief, the Supreme Court in *Biddle*[14] established that this inquiry would be made using U.S. principles.[15] In working out these U.S.

tax we mean a tax upon profits in excess of a given return upon capital."); *see also* GEORGE E. HOLMES, FEDERAL INCOME TAX, WAR-PROFITS AND EXCESS-PROFITS TAXES 14, 136 (1920) (stating excess profits taxes were imposed on only a portion of total income). The statute also refers to "war profits taxes." For an historical definition of a war profits tax, see W.G. McAdoo, Treasury Secretary, *Income, Excess Profits, and Estate Taxes: Hearings Before the House Comm. on Ways and Means* 15 (1918) ("By a war-profits tax we mean a tax upon profits in excess of those realized before the war."). By World War II, war-profits taxes were viewed as simply a subcategory of excess profits taxes. *See* KENNETH JAMES CURRAN, EXCESS PROFITS TAXATION at 2 (AM. COUNCIL ON PUB. AFFS. 1943) ("[T]he term 'excess profits tax' [today is used] to describe any levy that is confined to a segment of a taxpayer's income that is considered excessive, no matter by what standard of measurement it is determined."). Thus, for clarity to the modern reader, this paper discusses income taxes and excess profits taxes.

13. Burnet v. Chicago Portrait Co., 285 U.S. 1, 7 (1932) (the foreign tax credit is designed "to mitigate the evil of double taxation"); Am. Chicle Co. v. United States, 316 U.S. 450, 452 (1942) ("the purpose [of the foreign tax credit] is to avoid double taxation"); United States v. Goodyear Tire & Rubber, 493 U.S. 132, 139 (1989) ("The [legislative] history of the indirect credit clearly demonstrates that the credit was intended to protect a domestic parent from double taxation of its income."); Comm'r v. Am. Metal Co., 221 F.2d 134, 137 (2d Cir. 1955) ("The primary objective of [the foreign tax credit regime] is to prevent double taxation and a secondary objective is to encourage American foreign trade."). The legislative history is consistent and longstanding. *See* H. REP. 1337, 83RD CONG., 2D SESS. at 76 (1954) ("The [foreign tax credit] provision was originally designed to produce uniformity of tax burden among United States taxpayers, irrespective of whether they were engaged in business in the United States or engaged in business abroad."); S. REP. NO. 558, 73RD CONG 2D SESS. at 39 (1934) ("The present [foreign tax] credit . . . does relieve the taxpayer from a double tax upon his foreign income."); H.R. REP. 767, 65TH CONG., 2D SESS. (1918), 1939-1 C.B. (Part 2) 86, 93 (in explaining the rationale for a foreign tax credit, the legislative history stated as follows: "[w]ith the corresponding high rates imposed by certain foreign countries that taxes levied in such countries in addition to the taxes levied in the United States upon citizens of the United States place a very sever burden upon such citizens").

14. Biddle v. Comm'r, 302 U.S. 573, 579 (1938); *see also* United States v. Goodyear Tire & Rubber Co., 493 U.S. 132, 145 (1989) (reaffirming the approach contained in *Biddle*).

15. Although *Biddle* dealt with whether U.S. or foreign law should be used to determine the identity of the technical taxpayer of the foreign tax, subsequent cases used the Supreme Court's statement that U.S. law, not foreign law, should broadly be used for purposes of applying the U.S. foreign tax credit rules including with respect to the question of whether a foreign levy was an income tax. *See* Comm'r v. Am. Metal Co., 221 F.2d 134 (2d Cir. 1955).

principles,[16] early cases and IRS rulings held that taxes levied on "imputed income" could be eligible for U.S. foreign tax credit relief if net income was attempted to be taxed and was so taxed.[17] In general, these early cases and IRS rulings took an expansive view of credit eligibility, allowing the foreign country considerable latitude to define the manner in which a formulary tax arrived at the net income it intended to tax.[18] Thus, although the diversity of foreign taxes made the pre-1983 case law inconsistent at the outer edges, the substantive law was based on a principle-based approach: if the foreign tax was designed to tax net income and predominantly did tax net income in practice, then U.S. foreign tax credit relief was appropriate in order to prevent international double income taxation.[19]

Yet, a basic tension exists within the foreign tax credit regime, and the outworking of this basic tension has created increasing complexity and risks of international double income taxation. The basic tension at the core of the US foreign tax credit regime relates to the question of how the U.S. government should address the problem of cross-crediting excess foreign tax credits generated in objectionable transactions. In the cross-crediting fact pattern, the central question is whether one should think about prevention of international double income taxation narrowly (i.e., on only that

16. Some have called for a broader allowance of creditability of taxes beyond foreign income taxes. *See* Joseph Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes,* 39 TAX L. REV. 227, 230–31 (1984).

17. *See* Burke Bros. v. Comm'r, 20 B.T.A. 1657 (1930) (Indian tax on goat skins was calculated based on the difference between the average sales price of goat skins in their destination from the average sales price in Calcutta and reduced by certain transportation expenses; held, the presumptive tax was an income tax entitled to U.S. foreign tax credit relief);Keen v. Comm'r, 15 B.T.A. 1243 (1929) (a tax on presumed income was calculated on nondomiciled persons who maintained a residence in France; income was presumed to be a minimum of seven times the rental value of their residence; held, French tax was an income tax eligible for U.S. foreign tax credit relief); Hatmaker v. Comm'r, 15 B.T.A. 1044 (1929) (same); Rev. Rul. 53-272, 193-2 C.B. 56 (a Haitian tax was imposed on business income computed by multiplying the rental value of the land and buildings by five and assessing an income tax on this imputed income; IRS held this was an attempt to tax presumed income and was eligible for U.S. foreign tax credit relief); Rev. Rul. 56-658, 1956-2 C.B. 501 (Cuban tax on sugar mill operators assessed based on the amount of sugar produced times the average price for sugar and reduced by 60% for "deemed expenses" held that this presumptive tax was creditable as an attempt to tax income).

18. *See* ELISABETH OWENS, THE FOREIGN TAX CREDIT: A STUDY OF THE CREDIT FOR FOREIGN TAXES UNDER UNITED STATES INCOME TAX LAW 43–46 (1961).

19. *Id*. at 33–46.

particular item-of-income and its attributable foreign taxes on a stand-alone basis without cross-crediting excess taxes), or whether mitigation of international double income taxation should be evaluated on an overall basis (i.e., by aggregating foreign income and foreign taxes in some fashion). Congress and the Treasury Department have provided multiple responses to the cross-crediting phenomenon, and this multiplicity of responses has created considerable complexity.

As one longstanding answer to the central question posed by the cross-crediting phenomenon, Congress has formulated aggregate foreign tax credit limitation rules to regulate the scope and extent of cross-crediting of excess foreign tax credits since 1921.[20] Although these section 904 foreign tax credit limitation rules have changed in important ways over time,[21] the overall and separate limitation

20. *See* JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 at 862 (Comm. Print 1986) ("Congress recognized that, in certain situations, cross-crediting should not be permitted when it would distort the purpose of the foreign tax credit limitation. Congress believed that, in some cases, the ability of U.S. persons to average foreign tax rates for foreign tax credit limitation purposes and thereby reduce or eliminate the residual U.S. tax on their foreign income had undesirable consequences.").

21. *See* STAFF OF JOINT COMM. ON TAXATION, 112TH CONG., DESCRIPTION AND ANALYSIS OF PRESENT-LAW RULES RELATING TO INTERNATIONAL TAXATION SCHEDULED FOR A HEARING BEFORE THE HOUSE COMM. ON WAYS & MEANS at II.A.5.c, JCX-40-99 (June 28, 1999). Between 1918 and 1921, there were no limitations on the use of foreign tax credits. *See id*. at II.A.5.c, IV.B.2 (1999). As a result, taxpayers could utilize foreign tax credits to fully reduce their residual U.S. tax liability on both domestic source income and foreign source income. *See id*. at II.A.5.b, IV.B.2 (1999). However, in order to protect the U.S. tax jurisdiction's right to tax U.S. source income, Congress in 1921 enacted an overall foreign tax credit limitation that limited the usage of foreign tax credits to the U.S. taxpayer's U.S. tax liability on net foreign source income. *See* REVENUE ACT OF 1921, CH. 136, § 222(A)(5), 238(A), 904(A), 42 STAT. 227, 249, 258. Although not further discussed in this article, this limitation regime has taken various forms. In 1932, Congress decreed that taxpayers were required to use the lesser of an overall or per-country limitation. *See* Revenue Act of 1932, CH. 209, § 131(B), 47 STAT. 169, 211. In 1954, the overall limitation was repealed and only the per-country limitation regime existed. *See* I.R.C. §904 (2006). In 1960, taxpayers were given the option to use either a per-country or an overall limitation computation. *See* Act of Sept. 14, 1960, CH. PUB. L. NO. 86-780, § 1(A), 74 STAT. 1010. In 1976, the per-country limitation was repealed, and the law had come full circle to the position of 1921. *See* Tax Reform Act of 1976, CH. PUB. L. NO. 94-455, § 1031, § 904, 90 STAT. 1610, 1620–24. In 1986, the foreign tax credit basket rules were instituted along with an overall limitation regime to form the basis of current law. *See* Tax Reform Act of 1986, CH. PUB. L. NO. 99-514, § 1201, § 904(d), 100 STAT. 2085, 2520-28. Effective for years beginning in 2006, the American Jobs Creation Act of 2004 reduced the number of foreign tax credit baskets down to two baskets: the "passive basket" and the "general basket." *See* American Jobs Creation Act, PUB. L. NO. 108-357, 118 STAT. 1418 (2004).

regimes of section 904(a) and section 904(d) can be summarized as follows: the U.S. foreign tax credit regime is intended to prevent international double income taxation on an aggregate basis except to the extent necessary to protect the U.S. taxing jurisdiction on U.S. domestic source income and to protect against inappropriate cross-crediting of taxes against low-taxed passive basket foreign source income.[22]

Since at least 1975,[23] Congress has believed that section 904 is not a sufficient response in and of itself against perceived manipulation of the amount of allowable U.S. foreign tax credits generated in objectionable transactions. Thus, although section 904 expresses an overall or aggregate approach to the cross-crediting phenomenon, Congress has simultaneously pursued a parallel effort to outright disallow foreign tax credit relief for taxes generated in specific transactions where the amount of U.S. foreign tax credits generated in such transactions was perceived to be unreasonable. The ravages of this war have left their mark, causing the U.S. foreign tax credit regime to be described as "a byzantine structure of staggering complexity."[24]

The war against objectionable foreign tax credit transactions that generate artificially high amounts of U.S. foreign tax credits reached an important milestone in 2010 when Congress codified the economic substance doctrine in section 7701(o).[25] Section 7701(o)

22. I.R.C. § 904(a), (d) (2010).

23. In the author's view, war was declared with the enactment of I.R.C. § 907, and we have been witnessing continuing hostilities since then as the war shifts to other terrain, but the basic policy concern with abusive cross-crediting remains the central feature that has caused the law to evolve.

24. BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 15.21[1][a] (7th ed. Supp. 2014); *see also* Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 31 TAX NOTES INT'L 1177, 1200 (2003). To be faithful to this complexity, the author has sought to provide robust footnotes for the authorities that provide illumination for the tortured history that has led to the current complexity, but consistent with the thesis of this Article, the main text has sought to provide a straightforward articulation of the fundamental principles that should shape I.R.C. § 901 in the future.

25. Patient Protection and Affordable Care Act of 2010, PUB. L. NO. 111-148, § 1409(a). Codification of the economic substance doctrine was driven by a concern over tax shelters generally and not simply international foreign tax credit arbitrage transactions. *See* STAFF OF JOINT COMM. ON TAXATION, 111TH CONG, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL 2010 BUDGET PROPOSAL PART TWO: BUSINESS TAX PROVISIONS, at 36 (2009). However, even though section 7701(o) was intended as a broader anti-abuse provision, it was intended to also address foreign tax credit

codifies a broad anti-abuse rule that applies throughout the U.S. income tax laws.[26] Importantly, section 7701(o) makes clear that a taxpayer must have a substantial business purpose in order to claim tax benefits, including tax benefits arising from foreign tax credits. Furthermore, instead of providing a safe-harbor profit threshold, section 7701(o)(2)(A) requires that a transaction's expected nontax profit potential must be substantial in comparison to its expected tax benefits in order for the taxpayer's profit motive to constitute a substantial business purpose. Section 7701(o)(5)(D) allows the economic substance doctrine to be applied to a single transaction or to a series of transactions, thus clarifying that the government has the ability to disaggregate transactions and test the business purpose of each transaction step individually.[27] Section 7701(o)(2)(B) requires the Treasury Department to issue regulations (which as of yet it has not done)[28] to treat foreign taxes as an expense for purposes of

generator transactions and thus represents another bulwark that potentially impacts the taxpayer's eligibility to claim foreign tax credit relief in a meaningful way. *See* STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT", at 152–53 (2010).

26. A discussion of the codification of the economic substance doctrine outside of its impact in the foreign tax credit arena is beyond the scope of this Article and has received significant scholarly attention elsewhere. *See, e.g.*, Karen C. Burke, *Reframing Economic Substance,* 31 VA. TAX REV. 271 (2011); Martin J. McMahon, Jr., *Living With the Codified Economic Substance Doctrine,* 128 TAX NOTES 731 (Aug. 16, 2010); Bret Wells, *Economic Substance Doctrine: How Codification Changes Decided Cases,* 10 FLA. TAX REV. 411 (2010).

27. The legislative history states that this provision "does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine," thus by implication suggesting that a court should exercise this authority. *See* STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT", at 153 (2010). For cases that favorably allowed a bifurcation approach, see generally ACM P'ship v. Comm'r, 157 F.3d 231, 256 n. 48 (3d Cir. 1998); James v. Comm'r, 899 F.2d 905, 910 (10th Cir. 1990) ("The only transactions at issue in this case are the purported sales by the Communications Group to the joint ventures. These sales cannot be legitimized merely because they were on the periphery of some legitimate transactions."); Karr v. Comm'r, 924 F.2d 1018, 1023 (11th Cir. 1991) ("The activities of the other entities involved in exploiting the Koppelman process, however, cannot necessarily be attributed to POGA [the taxpayer]."); Long Term Capital Holdings v. United States 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd*, 150 F. App'x 40 (2d Cir. 2005).

28. In Notice 2010-65, 2010-40 I.R.B. 411, the IRS indicated its intention to issue implementing regulations but that "[i]n the interim, the enactment of the provision does not restrict the ability of the courts to consider the appropriate treatment of foreign taxes in economic substance cases."

calculating the reasonably expected pre-tax profit potential of a transaction. Section 7701(o) is a principled approach for regulating the abusive generation of excess foreign tax credits.

Unfortunately, prior to the enactment of section 7701(o), the Treasury Department and Congress adopted a number of ad hoc responses that were designed to attack objectionable foreign tax credit transactions,[29] and the result is that inferior and redundant disallowance provisions still clutter section 901. The added complexity of these obsolete anti-abuse bulwarks add a hodge-podge of substantive requirements that needlessly creates a risk of international double income taxation in nonobjectionable situations. It is time to repeal these obsolete provisions because incoherent foreign tax credit outcomes should not be tolerated when more targeted and more principled solutions already adequately address these objectionable foreign tax credit transactions.[30]

In the following Section, this Article addresses the pre-section 7701(o) effort to disallow foreign tax credit relief for taxes generated in objectionable transactions and evaluates which of these predecessor provisions serve a continuing purpose and which do not. Although the law in this area is nuanced, complex, and at times incoherent, the thesis of this Article is straightforward: U.S. tax law would be greatly improved if section 901 embodied a principled approach and if obsolete and incoherent aspects of section 901 were removed. Furthermore, where the foreign tax credit disallowance

29. The synthesis of the evolution of the law in the U.S. foreign tax credit regime and its ad hoc nature is more fully discussed and explored in Part II, *infra*.

30. The following testimony is particularly relevant:

> [T]he foreign tax credit rules have been repeatedly revised and have become exceedingly complex. The sources of complexity are varied, but their common denominator in my view can best be described as *the continual pursuit of technical perfection*. Trying to make sure that the rules operate as intended is of course a worthy goal for any set of tax rules, but in the case of the foreign tax credit, it has led over time to a system that makes comprehensive compliance and administration nearly impossible. . . . Changes to the foreign tax credit rules, from ad hoc tweaks to wholesale revision, make long-term business planning difficult for U.S. businesses, relative to their foreign competitors. The complexity and instability of the U.S. foreign tax credit rules impose a material, ongoing administrative burden on taxpayers and the government.

Statement of Dirk J. J. Suringa Before the House Committee on Ways & Means on the Need for Comprehensive Tax Reform to Help American Companies Compete in the Global Market and Create Jobs for American Workers (May 12, 2011), available at 2011 WTD 93-35, Tax Doc. 2011-10286.

provisions create an unnecessary risk of international double income taxation for U.S. multinational enterprises in situations where a U.S. taxpayer's foreign income has borne foreign income taxes in nonobjectionable transactions, a double tax outcome represents an "incoherent outcome." Such an outcome should not be tolerated given that needless instances of international double income taxation are out-of-step with the policy decisions of the major trading partners of the United States. As the United States becomes more and more isolated in its worldwide residency-based taxation of U.S. multinational enterprises, it simply must have a well-functioning U.S. foreign tax credit regime that achieves coherent outcomes. If section 901 is to fulfill its fundamental purpose, foreign tax credit relief should be available except where disallowance of such relief is necessary to quash objectionable foreign tax credit transactions. In Part II, this Article evaluates reasons that justified the added complexity in the foreign tax credit regime and why several of those reforms are no longer needed. Part III sets forth a synthesis of how Congress should proceed in light of the knowledge derived from the content of Part II.

II. THE KEY EPISODES IN THE FORTY YEARS' WAR

A. Desert Storm and the Oil Royalty Problem

1. Overkill occasioned by the dual capacity problem

The government declared war on objectionable transactions that inflated the amount of allowable U.S. foreign tax credits on March 29, 1975,[31] and the original fight was over oil—or more specifically over the creditability of the high extraction taxes imposed on dual capacity taxpayers in the natural resources extraction industry. During the 1960s and 1970s, foreign oil-producing governments (presumably in consultation with U.S. oil and gas producers) decided to forego charging higher royalties for the development of state-owned mineral interests and instead adopted special tax levies that had the effect of inflating the amount of U.S. foreign tax credits.[32]

31. Tax Reduction Act of 1975, Pub. L. No. 94-12, §601, 89 Stat 26.

32. *See* Rev. Rul. 55-296, 1955-1 C.B. 386 (Saudi Arabia imposed a surtax equal to a percentage of the posted price per barrel of oil was held to be a creditable income tax); Rev.

Congress realized that high extraction taxes could include disguised oil royalties and was concerned that allowing the cross-crediting of these high extraction taxes would lead to "artificial" and "excessive" amounts of U.S. foreign tax credit relief.[33] Consequently, in 1975 Congress decided to create a new foreign tax credit limitation for extraction taxes by enacting section 907.[34] In 1982, Congress modified section 907 to ensure that the maximum amount of creditable taxes for foreign oil and gas extraction income would not exceed the maximum U.S. tax rate.[35] Thus, Congress' response

Rul. 68-552, 1968-2 C.B. 306 (a surtax imposed by Libya based on a posted price per barrel on holders of petroleum concessions was held to be a creditable income tax). These two ruling were revoked by the IRS in Rev. Rul. 78-63, 1978-1 C.B. 228. For a discussion of this oil versus royalty problem and the artificial inflation of foreign tax credit benefits that provided the rationale for enacting section 907, see, for example, *Hearings on Foreign Tax Credits Claimed by U.S. Petroleum Companies before a Subcomm. of the H. Comm. on Gov't Operations*, 95th Cong. 2 (1977) (opening statement of Benjamin Rosenthal, Chairman, H. Comm. on Gov't Operations); H.R. REP. NO. 93-1502, at 61 (1974); *Hearings on "Windfall" Excess Profits Tax Before the House Comm. on Ways and Means*, 93rd Cong. 151 (1974) (testimony of Treasury Secretary Shultz). A report by the United States General Accounting Office asserted that Rev. Rul. 55-296 "assumed the nature of a foreign aid program in the 1950s with the knowledge and consent of the U.S. government." COMPTROLLER GENERAL, GEN. ACCOUNTING OFF., EMD-80-86, THE FOREIGN TAX CREDIT AND U.S. ENERGY POLICY 40 (1980). Professor Kingson, citing this report, asserted that providing foreign tax credits for what amounted to disguised royalties was done "in order to help that country at a time when direct aid was practically impossible" and later on other countries affirmatively exploited this technique to the detriment of the U.S. federal budget. Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151, 1153, 1265–67.

33. H.R. 91-413, 91st CONG. 89, 107, 110 (1969) ("Your committee recognizes the substantial difficulties of ascertaining in these situations whether a payment which is labeled as a tax payment is, in fact, a tax or a royalty. It does not believe, however, that it is appropriate to allow these "tax payments" to offset U.S. tax which would otherwise be imposed on other foreign income (either from the same country or from another country."). See also the following statement of Senator Long, which is illustrative of the Congressional attitude at that time:

> The [Saudi Arabian] king collected a royalty and he levied a tax on the companies. The companies concluded that they could only deduct their royalty but they were entitled to a tax credit if they were paying a tax. Therefore, some tax expert—and anybody with any brains as a tax expert would figure this one out—simply said "If Saudi Arabia were charging you the same amount as a tax, you would get a credit for it, which would be worth twice what a deduction would be worth. So why do you not tell the King over there that if he would assess that payment as a tax, you could afford to pay him a lot more, and you both would be better off, because you would owe the U.S. Government less?"

121 CONG. REC. 7490 (1975) (statement by Sen. Long).

34. Tax Reduction Act of 1975, Pub. L. No. 94-12, § 601, 89 Stat. 26.

35. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 211, 96 Stat. 324.

to the disguised oil royalty problem posed by high extraction taxes was to isolate royalties into their own separate foreign tax credit limitation in order to prevent the cross-crediting of these taxes against any non-extraction income.[36] In 2006, Congress simplified the various foreign tax credit limitation baskets[37] in section 904(d) to provide for a general basket and a passive basket.[38]

However, notwithstanding those simplification reforms that apply across all industries, section 907 remained unchanged. Consequently, the petroleum industry remained singled out for a specialized foreign tax credit limitation while all other industries benefitted from simplification.[39] In 2008, Congress combined foreign oil and gas extraction income and foreign oil-related income into a new combined category called "foreign oil and gas income" and applied the section 907 limitations on this new combined category.[40] The continued existence of the section 907 limitation regime would make sense if the specter of the historic disguised oil royalty problem were still present, but the reality is that this problem has already been addressed through the more targeted provisions set forth in Regulation section 1.901-2A, yet section 907 remains. Thus, seen in this historical context, singling out the extraction industry for specialized treatment is unnecessary once the disguised oil royalty problem has been addressed via other means and the remaining creditable amounts are otherwise nonobjectionable.

To understand why section 907 no longer serves a vital policy goal, the regulatory changes to section 901 that redundantly

36. The nuances of the limitation rules of section 907 and how they apply to the interplay between "foreign oil and gas extraction income" and "foreign oil related income" are adequately addressed elsewhere. *See* Heather Crowder & Caren Shein, *Energy Improvement and Extension Act of 2008—Throwing a Rope to the Ailing Financial Industry Tightens the Noose on Big Oil*, 38 TAX MGMT. INT'L J. 85 (2009); Javed A. Khokar, *TEFRA Enacts Stricter Rules to Govern Taxation of Foreign Oil and Gas Income*, 83 TAX MGMT. INT'L J. 85 (1983).

37. I.R.C. §§ 904(a), (d).

38. This Article does not seek to reconsider these section 904 reforms for simplifying the limitations on the aggregate cross-crediting of foreign tax credits other than to say that Congress has provided only two aggregate baskets for managing the potential cross-crediting of taxes arising from nonobjectionable transactions and to say that section 904 is the appropriate place to handle cross-crediting for nonobjectionable foreign taxes.

39. *See* Crowder & Shein, *supra* note 36, at 97.

40. *See* PUB. L. NO. 110-343, DIV. B, § 402 (2008). Thus, although high extraction taxes no longer are limited to solely foreign oil and gas extraction income, they still cannot be cross-credited against non-oil and gas income such as income arising from the chemical processing businesses of integrated companies.

attacked the disguised oil royalty problem must be understood. Even though Congress enacted section 907 to attack the disguised oil royalty problem,[41] the Treasury Department decided to join the fray by attacking the same problem using its regulatory authority under section 901. It was understood at the time the Treasury Department commenced its amendment of its section 901 regulations[42] in order to redundantly attack the disguised oil royalty problem.[43] At the

41. K. Dolan, *Foreign Tax Credit Regulations as They Affect Petroleum Income—Post Mortem and Analysis*, 83 TAX MGMT. INT'L J. 1, 3–6 (1983).

42. On November 17, 1980, the Treasury Department issued temporary regulations that articulated formal criteria that a foreign tax would be eligible for U.S. foreign tax credit relief *if and only if* the foreign tax was equivalent to an income tax in the United States sense, and for this test to be met the foreign tax must meet three formalistic tests (the gross receipts test, the realization test, and the net income test). T.D. 7739, Treas. Reg. § 4.901-2(c), 45 Fed. Reg. 75,647 (Nov. 17, 1980). For an analysis of these temporary regulations and their impact on prior law, see *Phillips Petroleum Co. v. Comm'r*, 104 T.C. 256, 285 (1995). The effect of the 1980 regulations was that a levy paid by a petroleum company to a mineral-owning foreign government could be denied in its entirety if the effective tax rate for petroleum taxpayers were significantly higher than those imposed on nonpetroleum taxpayers. T.D. 7739, Treas. Reg. § 4.901-2(d), 45 Fed. Reg. 75,647 (Nov. 17, 1980). Prior case law had determined that foreign taxes represented income tax if they were "substantial[ly] equivalent" in nature to the US income tax regime. *See, e.g.*, New York & Honduras Rosario Mining Co. v. Comm'r, 168 F.2d 745, 747 (2d Cir. 1948), *rev'g. and remanding* 8 T.C. 1232 (1947). However, on April 5, 1983, the Treasury Department stated that a foreign levy would be eligible for US foreign tax credit relief if an only if the "predominant character" of the foreign levy was that of an income tax in the US sense, and these final regulations left the underlying formalistic three-pronged test for creditability essentially unchanged. Notice of Proposed Rulemaking, 48 Fed. Reg. 14,641 (Apr. 5, 1983); Kevin D. Dolan, *General Standards of Creditability Under §§ 901 and 903 Final Regulations—New Words, Old Concepts*, 13 TAX MGMT. INT'L J. 167, 168 (1984) (stating that "one can only guess whether there is any difference between those general standards [predominant character versus substantially equivalent standard in earlier case law] in terms of the degree to which foreign law must conform to U.S. tax principles"). These 1983 proposed regulations also set forth detailed guidance on dual capacity taxpayers that granted partial foreign tax credit relief for dual capacity taxpayers if the foreign jurisdiction had a generally imposed income tax that applied outside the extraction industry. For an analysis of this regulatory evolution through the issuance of the 1983 proposed regulations, see Kevin D. Dolan, *Foreign Tax Credit Regulations as They Affect Petroleum Income—Post Mortem and Analysis*, 83 TAX MGMT. INT'L J. 3, 7–8 (1983). The final regulations issued on October 12, 1983 softened this dual capacity standard by providing partial foreign tax credit relief would be available for dual capacity taxpayers even if the foreign country did not have a generally applicable income tax that was imposed on non-extraction taxpayers. Dolan, *supra* note 41.

43. *See Hearing on Foreign Tax Credit for Oil and Gas Extraction Taxes before the House Comm. on Ways & Means*, 96th Cong. at 10–11 (1979) (stating that the proposed regulatory changes and proposals to tighten I.R.C. § 907 limitations were "parallel but independent efforts serving the same broad objective"); Dolan, *supra* note 41, at 3 ("Those outside of the petroleum industry must first understand that the [1980 and 1983 amendments to the] foreign tax credit regulations represent an administrative effort by the IRS and Treasury to

culmination of an intensive regulatory effort, the Treasury Department issued final section 901 regulations on October 12, 1983 that attacked the disguised oil royalty problem in two further (and redundant) ways.[44] First, the 1983 final regulations provide detailed rules in Regulation section 1.901-2A for dual capacity taxpayers that give the government the ability to bifurcate foreign levies between their tax and royalty components.[45] Second, the promulgation of Regulation section 1.901-2A was a principled and targeted response that provides an effective means of addressing the disguised oil royalty problem on its own and made section 907's overbroad prescription for the same problem a redundancy.[46]

As a result of much litigation that arose after its promulgation of regulations under section 901 to address the disguised oil royalty problem, a fascinating jurisprudence developed. This new jurisprudence allows extraction taxes to remain creditable income taxes in an amount in excess of the generally applicable income tax under the facts and circumstances test set forth in Treasury Regulation §1.901-2A(c).[47] The Treasury Department has indicated

limit the creditability of high rate foreign extraction taxes and that, absent concerns related to extraction taxes, the regulation project would probably not have been undertaken.").

44. T.D. 7918, 48 Fed. Reg. 46,272 (Oct. 12, 1983).

45. Dolan, *supra* note 41, at 168; Dolan, *supra* note 41, at 6–7. For a detailed discussion of the dual capacity taxpayer regulatory framework in Treas. Reg § 1.901-2A, see JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ B4.03 at ¶ [2][b] (ThompsonReuters/WG&L 2014 with updates through March 2014); Kevin Dolan & Caroline Dupuy, THE CREDITABILITY OF FOREIGN TAXES II.C.2, Tax Mgmt. Port. (2014 BNA) 901-2nd; Philip Postlewaite & Stephanie Renee Hoffer, INTERNATIONAL TAXATION: CORPORATE AND INDIVIDUAL § 6.06, § 6.10 (5th ed. 2010); Marc M. Levey, *Creditability of a Foreign Tax: The Principles, The Regulations, and the Complexity*, 3 J.L. & COM. 193, 216–24 (1983).

46. *See* David R. Tillinghast, *International Tax Simplification*, 8 AM. J. TAX POL'Y 187, 227–28 (1990); AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION: PROPOSALS ON UNITED STATES TAXATION OF FOREIGN PERSONS AND THE FOREIGN INCOME OF UNITED STATES PERSONS 338–41 (1987); Dolan & Dupuy, *supra* note 45, at VIII.B. (stating that "[s]ince both the TEFRA § 907 amendments and the specific economic benefit rules of the § 901 and § 903 regulations address the issue of high rate extraction taxes, the issuance of those regulations on the heels of TEFRA was arguably anticlimactic.").

47. *See, e.g.*, Exxon Corp. v. Comm'r, 113 T.C. 338 (1999) (UK petroleum tax held to be creditable); Texasgulf, Inc. v. Comm'r, 107 T.C. 51 (1996), *aff'd*, 172 F.3d 209 (2d Cir. 1999) (holding that Ontario mining tax was creditable); Phillips Petroleum Co. v. Comm'r, 104 T.C. 256 (1995) (Norway's surtax on petroleum activities was held to be creditable under 1980 temporary regulations); Rev. Rul. 76-215, 1976-1 C.B. 194 (the Indonesian petroleum

that Congress should modify the dual capacity standard, presumably to reverse taxpayer victories under the facts and circumstances test in Treasury Regulation §1.901-2A(c). However, the Treasury Department can bring about its reform proposal simply by affirmatively removing its own facts and circumstances test contained in Treasury Regulation §1.901-2A(c) and instead requiring taxpayers to use the safe harbor of Treasury Regulation §1.901-2A(d). If this regulatory amendment were made, the outcome of these changes would mimic the result afforded under prior temporary regulations and would achieve the result that the Treasury Department inexplicably says it is now stymied from achieving.[48] Thus, the critical point for policy-makers and scholars is that any further reform efforts to address the disguised oil royalty problem can and should be targeted at Treasury Regulation §1.901-2A without the need for further redundant measures such as section 907.

However, even though reforming Regulation section 1.901-2A would have been sufficient to solve the disguised oil royalty problem, the Treasury Department still forged ahead to adopt a separate line of attack on the disguised oil royalty problem. It revised the general foreign tax credit eligibility standards under Regulation section 1.901-2 to mandate that all foreign levies must satisfy a mandatory, formalistic, three-pronged test in order to be eligible for U.S. foreign tax credit relief. This regulatory change was a further redundant attack against the dreaded disguised oil royalty problem.[49]

Regulation section 1.901-2 begins in a noncontroversial manner by stating that a foreign tax's "predominant character" must be that of an income tax in order to be eligible for U.S. foreign tax credit

tax was modified after Rev. Rul. 76-215 had denied its eligibility for foreign tax credit relief and the modified version was found to be eligible for U.S. foreign tax credit relief).

48. *Compare* TREASURY DEPARTMENT, GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROPOSALS at 26–27 (Feb. 2016), *with* Treas. Reg. § 1.901-2A(d) (sets forth standard advocated by the Treasury Department in its reform proposal, but this provision is an elective safe harbor; the Treasury Department can simply mandate this standard instead of allowing its elective application), *and* Notice of Proposed Rulemaking, 48 Fed. Reg. 14,641 (Apr. 5, 1983) (sets forth standard in proposed regulations that the Treasury Department now says that it likes better).

49. *See* Glenn E. Coven, *International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes*, 4 FLA. TAX REV. 83, 100–05 (1999). The formalistic, predominant character standard set forth in the 1983 final regulations was originally developed by the IRS chief counsel's office as part of its litigation strategy against the disguised oil royalty problem. *See, e.g.,* I.R.S. Gen. Couns. Mem. 36,540 (Jan. 5, 1976); I.R.S. Gen. Couns. Mem. 37,263 (Sept. 21, 1977); I.R.S. Gen. Couns. Mem. 36,552 (Jan. 19, 1976).

relief.[50] The 1983 final regulations further provide that a foreign levy meets this "predominant character" standard if the foreign tax is likely to reach net gain in the normal circumstances in which it applies.[51] This "predominant character" phraseology and the desire to determine whether "net gain"[52] is being taxed in the foreign country harkens back to prior judicial case law that took a holistic, substance-over-form inquiry of whether a foreign tax levy was eligible for U.S. foreign tax credit relief. However, it is at this point that the 1983 final regulations diverge from prior case law, stating that a tax will be conclusively determined to not meet the "predominant character" standard unless the foreign tax levy satisfies three specific formal design features.[53] Specifically, the foreign tax must satisfy the realization test,[54] the gross receipts test,[55] and the net income test.[56]

These three formal regulatory tests are drawn from several lower court decisions in the mid-1970s that arguably endorsed the idea that a foreign tax levy must meet certain pre-defined formalistic criteria in order for to be considered an income tax in the U.S. sense.[57] Relying on the reasoning in these lower court decisions, the

50. Treas. Reg. § 1.901-2(a)(1)(ii).

51. Treas. Reg. § 1.901-2(a)(3) (as amended in 2012).

52. Treas. Reg. § 1.901-2(b).

53. Treas. Reg. § 1.901-2(b)(1) (as amended in 2012). For an excellent summary of the prior case law and the efforts made in the 1983 final regulations to tighten up the standards for allowing foreign tax credit relief, see Dolan, *supra* note 41.

54. Treas. Reg. § 1.901-2(b)(2)(i) (as amended in 2012) ("A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed (A) [u]pon or subsequent to the occurrence of events ('realization events') that would result in the realization of income under the income tax provisions of the Internal Revenue Code.").

55. Treas. Reg. § 1.901-2(b)(3)(i) (as amended in 2012) ("A foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of (A) [g]ross receipts.").

56. Treas. Reg. § 1.901-2(b)(4)(i) (as amended in 2012) ("A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts . . . to permit (A) [r]ecovery of the significant costs and expenses . . . attributable, under reasonable principles, to such gross receipts; or (B) [r]ecovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses.").

57. *See* Inland Steel Co. v. United States, 677 F.2d 72, 86–87 (Ct. Cl. 1982) ("The [foreign tax] in its structure and express provisions thus permits the tax to be imposed on unrealized income, a generally impermissible result for an income tax in the United States sense."); Bank of Am. Nat'l Tr. & Sav. Ass'n v. United States, 459 F.2d 513, 523 (Ct. Cl. 1972) (states that U.S. foreign tax credit relief under § 901(b)(1) is available only if a "foreign

1983 final regulations sought to stake out clear and prescriptive standards for identifying the essential design features that a foreign tax must have to be eligible for U.S. foreign tax credit relief.[58]

As to the net income test, a foreign net-basis tax is an income tax in the U.S. sense if and only if the foreign levy allows for the recovery of the taxpayer's significant costs.[59] Instead of allowing

income tax[is] designed to fall on some net gain or profit, and includes a gross income tax if, but only if, that impost is almost sure, or very likely, to reach some net gain because costs or expenses will not be so high as to offset the net profit"); Bank of Am. Nat'l Tr. & Sav. Ass'n v. Comm'r, 61 T.C. 752, 762–63 (1974) (stating the following as to tests articulated by the Claims Court were appropriate: "Perhaps the test which we and the Court of Claims have articulated will not provide that magic touchstone whereby every situation in this area can be precisely located in the spectrum of foreign taxes ranging from pure net income taxes on one end to pure excise, sales, or privilege taxes on the other. But we are convinced that the test is not 'manufactured out of whole cloth,' as petitioner would have us believe, and that it provides a rational and manageable basis for interpretation of section 901(b)(1).").

58. T.D. 7918, 1983-2 C.B. 113, 114. After endorsing the cases mentioned in *supra* note 50, as authority for mandating that each foreign tax must separately and formalistically satisfy pre-defined formal design features of the gross receipts test in Treas. Reg. §1.901-2(b)(3)(i), a realization test in Treas. Reg. §1.901-2(b)(2)(i), and a net income test in Treas. Reg. §1.901-2(b)(4)(i), the regulations then provided that *each such test must be separately met* in order for a foreign levy payment to qualify for U.S. foreign tax credit relief. The Treasury Department was transparent in its desire, stating in the preamble to T.D. 7918 as follows: "The regulations set forth three tests for determining if a foreign tax is likely to reach net gain: the realization test, the gross receipts test, and the net income test. All of these tests must be met in order for the predominant character of the foreign tax to be that of an income tax in the U.S. sense." The government has been adamant in its litigating positions that the three-part test set forth in Regulation section 1.901-2(b) must be met in form in order for a foreign tax to be eligible for U.S. foreign tax credit relief. *See* Brief for Respondent at 95, PPL Corp. v. Comm'r, 135 T.C. 304 (2010) (No. 25393-07) ("If a foreign tax fails to satisfy the 'net gain' requirement of the Regulations, it is not creditable for U.S. tax purposes. And the 'net gain' requirement requires an analysis of neither the underlying purpose of the foreign tax nor the components of the foreign tax (to determine, for instance, if the Profit-Making Value is a generally accepted method for valuing a Windfall Tax Company). Simply, the 'net gain' requirement requires that a foreign tax satisfy each of the three objective tests (realization, gross receipts, and net income) to be creditable. The U.K. Windfall Tax fails to satisfy each of the three net gain tests, and therefore it is not a creditable tax."); *Brief for Respondent*, *supra*, at 98 ("The regulation provides three specific tests, all of which a foreign tax must satisfy to be deemed an income tax in the U.S. sense, and therefore creditable. These regulatory tests neither permit nor require the application of these tests to the 'substance' of the tax."); Brief for Respondent at 38, Entergy v. Comm'r, 100 T.C.M. (CCH) 202 (2010) (No. 25132-06) ("Finally, analysis of pre-regulation case law does not assist in the resolution of this case, since petitioners do not dispute that the U.K. Windfall Tax must satisfy all three of the net gain requirements of the regulations to qualify as a creditable tax.").

59. *See* Treas. Reg. § 1.901-2(b)(4)(i) (as amended in 2012). This net income requirement was derived from several lower court decisions that pre-dated the regulations. *Bank of Am. Natl. Trust & Sav. Ass'n*, 459 F.2d at 519 (Court of Claims stated that foreign levy must attempt to reach some net gain in the normal circumstances in which the tax

deductions for actual significant expenses, foreign law can allow reductions of the tax base as long as the substitute methodology is likely to produce an amount that approximates, *or is greater than*, a recovery of *all significant* costs and expenses.[60] Furthermore, although foreign law can allow for a different period for cost recovery than is allowed under U.S. law, the net income requirement is not met if the deferral of cost recovery effectively represents a denial of such recovery.[61] In addition, the net income test in the 1983 final regulations provides that a foreign tax levy must usually allow losses incurred in any aspect of a trade or business in the taxing country to offset profits earned in other aspects of the business.[62] Taken as a whole, the 1983 final regulations posit that an income tax in the U.S. sense must allow for a recovery of *all* significant business expenditures (or their economic equivalent) in some reasonable period.

Thus, except for gross withholding taxes imposed on investment income where a substantial business expense is unlikely to exist, the 1983 final regulations purport to draw a bright line to prevent formulary taxes from being creditable when assessed on active business income. The issue of whether section 901 was intended to provide relief only for net income taxes or for gross income taxes has been the subject of scholarly debate for over sixty years, and there is little indication that the original Congress that adopted the U.S.

applies); *see also Bank of Am. Natl. Trust & Sav. Ass'n*, 61 T.C. at 760 (Tax Court accepted that the governing test to determine whether a foreign tax qualifies as a creditable income tax is whether the tax was "designed to fall on some net gain or profit").

60. Treas. Reg. § 1.901-2(b)(4)(i)(B) (as amended in 2012). In *Texasgulf, Inc. v. Comm'r*, 107 TC 51, 72 (1996), *aff'd*, 172 F.3d 209 (2d Cir. 1999), the court held that a "processing allowance" under an Ontario mining tax effectively compensated for a lack of deductions for interest, royalties, and other items because multiyear data for the taxpayer and most other companies subject to the tax showed that the allowance exceeded the disallowed costs in the aggregate and in most years. "Use of aggregate data is appropriate because a tax is or is not creditable for all taxpayers subject to it." Exxon Corp. v. Comm'r, 113 T.C. 338 at *12 (1999) (PRT imposed by the United Kingdom was held to have met the net income requirement notwithstanding the lack of deduction for interest expense because "special allowances and reliefs" were given that as a factual matter exceeded the disallowed interest expense).

61. Treas. Reg. § 1.901-2(b)(4)(i) (as amended in 2012).

62. *See* Treas. Reg. § 1.901-2(b)(4)(ii) (as amended in 2012) (if a loss in one activity of the business is never allowed against income from other activities of the business, the loss must be carried to other periods so that it can be used as a deduction against profits from the same activity in other periods, and the period of carryover and carryback must not be so restricted so as to effectively represent a denial of cost recovery).

foreign tax credit gave this issue much thought.[63] Although Congress' early desire may be in doubt, there is no doubt that the Treasury Department, by promulgating its 1983 final regulations, wanted to overturn prior case law[64] to the extent that prior case law allowed U.S. foreign tax credit relief for a gross formulary tax on business profits that did not provide a deduction for all significant business expenses. Consequently, whereas the pre-1983 case law had provided for a broad subjective inquiry into whether the intent of the foreign levy was to reach net income,[65] commentators[66] and the courts[67] recognized early on that the 1983 regulations represented a change to prior law as they attempted to provide a prescriptive list of formal requirements that in form must be met. To ensure nobody missed this conclusion, after issuing the 1983 final regulations, the

63. *See* Stanley S. Surrey, *Current Issues in the Taxation of Corporate Foreign Investment,* 56 COLUM. L. REV. 815, 819–22 (1956) (makes this point); *see also* H.R. REP. NO. 65-767 at 11 (1918); 56 CONG. REC. 667–78 (1918).

64. For an example of a pre-1983 case that the 1983 final regulations intended to overrule, see *Seatrain Lines Inc. v. Comm'r*, 46 B.T.A. 1076 (1942), *nonacq.* 1942-2 C.B. 31. In *Seatrain*, Cuba had imposed a formulary tax upon realized gain. In order to resolve a dispute over the amount of deductible expenses, the Cuban government substituted a 3% tax on gross shipping income for a 6% tax on net profits. The Board of Tax Appeals held that the tax was creditable because the tax was imposed on gain realized under U.S. standards and because the intent of the lower gross tax was to simulate the earlier net income tax at that higher rate. For a discussion of this more lenient line of authority, see Owens, *supra* note 18, at 46. For an excellent summary of the prior case law and the efforts made in the 1983 final regulations to tighten up the standards for allowing foreign tax credit relief, Dolan, *supra* note 41; *see also* Coven, *supra* note 49, at 100–05, 114–16.

65. *See* Bank of Am. Nat'l. Tr. & Sav. Ass'n. v. United States, 459 F.2d 513, 519 (Ct. Cl. 1972).

66. *See* Dolan, *supra* note 41, at 169 (stating that "[f]ortunately, the regulations provide specific tests for determining whether the general Bank of America standard is satisfied."). Mr. Dolan was in the government and played an active role in drafting the 1983 regulations.

67. *See* Texasgulf, Inc. v. Comm'r, 107 T.C. 51, 73 n.3 (1996), *aff'd*, 172 F.3d 209 (2d Cir. 1999) (quoting Dolan commentary cited in note 42 with approval). In discussing the import of the 1983 final regulations, the Tax Court observed as follows:

> The preamble states that the regulations adopt the creditability criterion from certain cases to use in deciding whether the predominant character of a foreign tax is likely to reach net gain for purposes of section 1.901-2(a)(3)(i), Income Tax Regs. The preamble states that a tax is likely to reach net gain if it meets three tests provided in the regulations. The regulations provide objective and quantitative standards *that were not used in cases which decided creditability of foreign taxes before the regulations became final.* Regulations can supersede prior case law to the extent that they provide requirements and definitions not found in prior case law. *See* Bowater Inc. v. Comm'r, 101 T.C. 207, 212 (1993); Nissho Iwai Am. Corp. v. Comm'r, 89 T.C. 765, 776-77 (1987); *Texasgulf, Inc.*, 107 T.C. at 73 n.3 (emphasis and scoring added).

IRS revoked fifty years of prior section 901 revenue ruling positions[68] and reversed long-standing IRS acquiescences in prior section 901 cases[69] whenever those prior rulings were inconsistent with the government's new predominant character standard for credit eligibility.[70]

The formality imposed by the 1983 final regulations had a specific goal, namely to represent a redundant attack on the objectionable disguised oil royalty problem that at the time was taking all the oxygen out of the room.[71] In this regard, the objectionable extraction taxes often were levied based at least in part on a formulary basis.[72] Because of this, tightening the section 901 eligibility standards with a new predominant character standard that required cost recovery for all of the significant costs (or allow for a substitute deduction equal to or greater than such costs) provided another cogent basis to disallow credit relief for disguised oil royalties.[73]

68. Initially, the IRS did not challenge the foreign tax credit generator aspects of foreign taxes paid under production sharing agreements that generated inflated amounts of U.S. foreign tax credits. *See* Rev. Rul. 69-388, 1969-2 C.B. 154 (Indonesia imposed a special tax by contract for companies operating in oil and gas producing regions in Indonesia held to be a creditable "in lieu of" tax under I.R.C. § 903; this ruling was colloquially known and "Indonesia I" in the industry). The IRS subsequently revoked Indonesia I. *See* Rev. Rul. 76-215, 1976-1 C.B. 194 (stating that the payment was in substance a royalty, not a tax, and therefore not eligible for U.S. tax credit relief under either I.R.C. § 901 or I.R.C. § 903; this ruling was colloquially known as "Indonesia II" in the industry). But, by the mid-1970s, the IRS decided to launch its own assault on these "disguised oil royalty arrangements" even as Congress added a new foreign tax credit basket to address this same phenomenon. *See* Coven, *supra* note 49, at 100–05 (analyzing reversal of the historic IRS position as set forth in its prior rulings).

69. *See* Rev. Rul. 84-172, 1984-2 C.B. 315 (declaring each of the following rulings obsolete after adoption of final regulations: Rev. Rul. 76-215, 1976-1 C.B. 194; Rev. Rul. 78-61, 1978-1 C.B. 221; Rev. Rul. 78-62, 1978-1 C.B. 226; Rev. Rul. 78-63, 1978-1 C.B. 228); *see also* Coven, *supra* note 49, at 101–03.

70. *See* Coven, *supra* note 49, at 101–03.

71. Kevin D. Dolan, *Foreign Tax Credit Regulations as They Affect Petroleum Income—Post Mortem and Analysis*, 83 TAX MGMT. INT'L J. 3–4 (1983).

72. *See e.g.*, Rev. Rul. 69-388, 1969-2 C.B. 154, revoked by Rev. Rul. 76-215, 1976-1 C.B. 194; Rev. Rul. 55-296, 1955-1 C.B. 386 (Saudi Arabia's imposed surtax equal to a percentage of the posted price per barrel of oil was held to be a creditable income tax); Rev. Rul. 68-552, 1968-2 C.B. 306 (a surtax imposed by Libya based on a posted price per barrel on holders of petroleum concessions was held to be a creditable income tax). Rev. Rul. 55-296 and Rev. Rul. 68-552 were both revoked by Rev. Rul. 78-63, 1978-1 C.B. 228. For a discussion of this parallel effort, see Coven, *supra* note 49, at 114–16.

73. *See* Coven, *supra* note 49, at 114–16.

Thus, as of the end of 1983, three redundant policy responses had been leveled against the singular disguised oil royalty problem. First, section 907 set forth a specialized limitation for extraction taxes to prevent the cross-crediting of extraction taxes. Second, new dual capacity taxpayer regulations under Regulation section 1.901-2A denied foreign tax credit relief for the royalty portion of any foreign tax levy. Third, the foreign tax credit eligibility standards set forth in Regulation section 1.901-2(b) were tightened for all taxpayers to make it much more difficult for formulary taxes to be creditable. Prior to the Supreme Court's decision in *PPL Corp. v. Commissioner*,[74] the revolutionary nature of these changes could not be underestimated. As Professor Coven forcefully pointed out fifteen years ago, the appropriate U.S. response to the disguised oil royalty problem was to treat the portion of any purported foreign tax payment as a non-tax payment to the extent such payment was made in return for a specific economic benefit.[75] But unfortunately, the government's response was much more expansive than necessary.

The Treasury Department's detailed dual-capacity regulation set forth in Regulation section 1.901-2A provides an adequate means to solve the dual-capacity problem by bifurcating payments made by a dual-capacity taxpayer into a tax component and a non-tax component.[76] After this bifurcation, Regulation section 1.901-2A provides that only the portion of the bifurcated payment that is considered a tax payment is eligible for U.S. foreign tax credit relief—assuming all other section 901 requirements are satisfied.[77] Thus, it was not necessary for the Treasury Department to adopt the formalistic three-pronged predominant character standard in Regulation section 1.901-2(b). The regulation redundantly tried to solve the same disguised oil royalty problem that Regulation section 1.901-2A is better designed to solve. In addition, Regulation section 1.901-2A, once adopted, made section 907 redundant as well.[78] In other words, the Treasury Department responded to one observable problem (the disguised oil royalty problem) with complex and

74. *See* PPL Corp. v. Comm'r, 133 S. Ct. 1897 (2013).

75. *See* Coven, *supra* note 49, at 103–04.

76. *See* Treas. Reg. §1.901-2A (1983); *see also* authorities cited in note 42.

77. Treas. Reg. §1.901-2A(a)(1).

78. *See* authorities cited in note 41.

redundant changes to the foreign tax credit regime when only one principled response was needed.

Furthermore, unlike Regulation section 1.901-2A's targeted and coherent approach to the objectionable disguised oil royalty problem, Congress' overbroad enactment of section 907 and the Treasury Department's overbroad effort to rewrite the foreign tax credit eligibility standards lead to incoherent outcomes. These redundant attacks restrict or deny foreign tax credit relief for foreign income taxes that are paid in nonobjectionable ways and are not disguised oil royalties.

2. PPL*'s damage to the formalistic predominant character standard*

This prior analysis represents the factual background that should be considered when one approaches the Supreme Court's decision in *PPL Corp. v. Commissioner*.[79] The U.K. windfall profits tax in the PPL litigation provided for a one-time twenty-three percent formulary assessment tax on all privatized utility companies. This tax applied to the difference between a company's "profit-making value"[80] and the price for which the company was privatized.[81]

Under the case law that pre-dated the 1983 regulatory changes, the above-described U.K. windfall profits tax would have been eligible for U.S. foreign tax credit relief. Earlier iterations of U.K. excess profits tax regimes considered in the pre-1983 period had been found to be creditable,[82] and IRS administrative practice stated that a wide range of analogous excess profits regimes met the

79. *See PPL Corp.*, 133 S. Ct. 1897.

80. For this purpose, "profit-making value was defined as its average annual profit per day over an initial period that was generally a four-year period and then this amount was multiplied by nine. The number nine was chosen as a baseline 'price-to-earnings ratio.' Although described as a tax on excess value, the tax had the economic effects of a tax on excess profits because the calculation of 'value in profits terms' was based on average net income over the four-year period, rather than on an actual measure of value (which could have easily been established from market data) and so from an economic point of view the U.K. windfall profits tax was a tax on excess profits. *See* Brief for Amici Curiae Rosanne Altshuler, Richard M. Bird, Malcom Gillis, Arnold C. Harberger, Gary C. Hufbauer, Charles E. McLure, Jr., Jack Mintz, & George R. Zodrow at 8–9, PPL Corp. v. Comm'r, 133 S. Ct. 1897 (2013) (No. 12-43).

81. *See* Entergy v. Comm'r, 683 F.3d 233, 234 (5th Cir. 2012).

82. *See* Robertson v. Comm'r, 176 F.2d 704 (3d Cir. 1949); Ethyl Corp. v. United States, 75 F. Supp. 461 (Ct. Cl. 1948); Colombian Carbon Co. v. Comm'r, 25 B.T.A. 456 (1932), *acq.*, 1932-1 C.B. 2.

eligibility standards set forth in the pre-1983 case law.[83] The IRS had even ruled that a tax levy imposed on average profits spanning multiple years, much like the U.K. windfall profits tax that was the subject of the PPL litigation, was entitled to U.S. foreign tax credit relief.[84]

But these cases and administrative pronouncements preceded the 1983 regulatory amendments to Regulation section 1.901-2(b), and, as the Tax Court recognized in its *Texasgulf* decision, "[r]egulations [under Regulation section 1.901-2] can supersede prior case law to the extent that they provide requirements and definitions not found in prior case law."[85] Thus, the *PPL* case is interesting precisely because the taxpayer substantively satisfied the standards for U.S. foreign tax credit relief under the historic pre-1983 case law criteria (a conclusion the IRS National Office appears to have accepted before the litigation or at least did not refute).[86] Even so, the U.K. windfall profits tax failed to comply with the three-pronged predominant character standard that was put into place in response to the disguised oil royalty problem.

To add further intrigue, the IRS asserted the formalistic aspects of the predominant character standard set forth in Regulation section 1.901-2(b) against PPL even though the government did not

83. *See* Rev. Rul. 68-318, 1968-1 C.B. 342 (Italian tax on profits in excess of six percent of capital); Rev. Rul. 56-51, 1956-1 C.B. 320 (Cuban tax on profits in excess of 1/10th of estimated real worth of capital). Another ruling concluded that a tax imposed at variable rates was creditable. Rev. Rul. 74-435, 1974-2 C.B. 204 (Swiss Cantonal tax imposed at variable rates on multi-year profits was creditable).

84. *See* Columbian Carbon Co. v. Comm'r, 25 B.T.A. 456, 463 (1932), *acq.*, 1932-1 C.B. 2 (Service contested timing of accrual, but not creditability of U.K. tax based on average profits of three-year period preceding assessment year); *see also* Rev. Rul. 69-446, 1969-2 C.B. 150 (Swiss National Defense Tax, which is imposed on average profits for the two years preceding the assessment year, is an income tax).

85. Texasgulf, Inc., 107 T.C. at 69. See quote from *Texasgulf, Inc* in note 60. Also, the government was categorical to the Tax Court, stating that the pre-1983 case law was of "little consequence" and that the 1983 final regulations superseded prior case law. *See* Reply Brief of Respondent, at 93–99, PPL Corp. v. Comm'r, 135 T.C. 304 (2010) (No. 25393-07).

86. It is interesting to note at this point that the IRS National Office appeared to have agreed that the pre-1983 case law was supportive of the taxpayer's position even before the PPL litigation, but after analyzing that favorable case law the IRS National Office then argued that the government had authority to change the standards for creditability in its final 1983 Treasury regulations and then stated as follows: "analysis of pre-regulation case law does not assist in the resolution of this case, since Taxpayer does not dispute that the U.K. Windfall Tax must satisfy the net gain test of the regulations to qualify as a creditable tax." PLR 200719011 (May 11, 2007).

contend that PPL was a dual-capacity taxpayer or that the U.K. windfall profits tax was a disguised royalty.[87] Rather, the government used the overbroad formality of Regulation section 1.901-2(b) to make an incoherent attack on the foreign tax credit eligibility of foreign taxes paid by PPL in a nonobjectionable transaction. PPL, therefore, was at risk of being counted as collateral damage in the government's foreign tax credit war.

The Tax Court held that PPL was entitled to foreign tax credit relief, finding as a factual matter that the U.K. windfall profits tax was designed to reach net income and did in fact tax net income in all cases.[88] On appeal, the Third Circuit reversed the Tax Court's decision.[89] In its appeal to the Third Circuit, the government asserted,[90] and the Third Circuit accepted,[91] that the U.K. windfall profits tax used a tax base greater than gross receipts and therefore failed the gross receipts test contained in the 1983 final regulations.[92] As an additional ground for reversal, the government asserted,[93] and

87. *See* PPL Corp. v. Comm'r, 133 S. Ct. 571 (2013).

88. The Tax Court stated as follows:

> Parliament did, in fact, enact a tax that operated as an excess profits tax for the vast majority of the windfall tax companies. The design of the windfall tax formula made certain that the tax would, in fact, operate as an excess profits tax for the vast majority of the companies subject to it.
>
> Because both the design and effect of the windfall tax was to tax an amount that, under U.S. tax principles, may be considered excess profits realized by the vast majority of the windfall tax companies, we find that it did, in fact, "reach net gain in the normal circumstances in which it [applied]", and, therefore, that its "predominant character" was "that of an income tax in the U.S. sense."

PPL Corp., 135 T.C. at 340–41.

89. *See* PPL Corp. v. Comm'r, 665 F.3d 60 (3d Cir. 2011).

90. *See* Opening Brief for the Appellant at 23–29, 30–33, PPL Corp. v. Comm'r, 665 F.3d 60 (3d Cir. 2011) (No. 11-1069). The government repeated this argument in its briefs before the Supreme Court. *See* Brief of the Respondent at 33–43, PPL Corp. v. Comm'r, 133 S. Ct. 1897 (No. 12-43).

91. *PPL Corp.*, 665 F.3d at 67–68 (observing that the Third Circuit so held).

92. *Id*. at 65 ("In our view, PPL's formulation of the substance of the U.K. Windfall Profits Tax is a bridge too far. No matter how many of PPL's proposed simplifications we may accept, we return to a fundamental problem: the tax base cannot be initial period profit alone unless we rewrite the tax rate. Under the Treasury Department's regulation, we cannot do that."); Opening Brief for the Appellant at 31–32, *PPL Corp.*, 665 F.3d 60 (No. 11-11069) (The windfall profits tax was then "imposed on the *difference* between profit-making value and flotation value, and a tax on the value of property does not have the predominant character of an income tax in the U.S. sense. Thus, the tax base for the windfall profits tax was completely divorced from any traditional concept of gross receipts.").

93. The government asserted the following in its Opening Brief at 24–25, *PPL Corp.*, 665 F.3d 60 (No. 11-1069):

the Third Circuit accepted,[94] that the U.K. windfall profits tax also failed to satisfy the realization test set forth in the 1983 final regulations.[95] Because these formalistic criteria were not satisfied, the Third Circuit found that the U.K. windfall profits tax failed two out of the three mandatory tests contained in the 1983 final regulations' predominant character standard and therefore was ineligible for U.S. foreign tax credit relief.[96]

The Third Circuit denied foreign tax credit relief to the taxpayer in *PPL*, but it nowhere contested the Tax Court's factual determination[97] that the U.K. windfall profits tax actually achieved its intended operational purpose of taxing only net income.[98] Thus, in one sense, the *PPL* case represents an odd case for disallowing foreign tax credit relief because the Tax Court made a finding of fact that the U.K. windfall profits tax operated as a tax levied on net income[99] and resulted in a levy of some amount less than total net profits in all cases.[100] Yet, the Third Circuit held that the U.K.

> [I]t is well-established that under U.S. tax law, a tax on value or appreciation is not a tax on realized income (and thus does not have the predominant character of an income tax in the U.S. sense. *See* Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 559 (1991); Tatum v. Comm'r, 400 F.2d 242, 247 (5th Cir. 1968) ("Thus far Congress has not seen fit to tax unrealized appreciation in property value.").
>
> Nor was the windfall tax a tax upon previously realized income. The fact that a company's profit making value was determined by reference to past profits does not convert the windfall tax into a tax on those past profits. Indeed, a tax on income-producing property does not become an income tax simply because the property's value is calculated for tax purposes by reference to the amount of income the property generates.

The government repeated these arguments before the Supreme Court. *See* Brief of the Respondent at 35–36, *PPL Corp.*, 133 S. Ct. 1897 (No. 12-43).

94. *See PPL Corp.*, 665 F.3d at 67 n.3 (observing that Third Circuit so held).

95. *Id.*

96. *See PPL Corp.*, 665 F.3d at 67 n.3.

97. The Tax Court made specific findings of fact indicating that they found that the legislative intent for the U.K. windfall profits tax was to assess a tax on excess profits and the Third Circuit nowhere contests these findings. PPL Corp. v. Comm'r, 135 T.C. 304, 339–40 (2010), *rev'd*, 665 F.3d 60 (3d Cir. 2011).

98. PPL Corp. v. Commissioner, 133 S. Ct. 1897, 1903 (2013) (noting that the Third Circuit explicitly discussed its concerns regarding the gross receipts and realization requirements).

99. The Third Circuit is silent on this point, but the Fifth Circuit makes the statement categorically as follows: "the tax *only* reached — and only *could* reach — utilities that realized a profit in the relevant period, calculating profit in the ordinary sense (*e.g.* by subtracting operating expenses associated with generating the utilities' income). This satisfies the net income requirement." *See* Entergy v. Comm'r, 683 F.3d 233, 236 (5th Cir. 2012).

100. *PPL Corp.*,135 T.C. at 338, 341.

windfall profits tax was non-creditable for U.S. foreign tax credit purposes because the formal design of the U.K. windfall profits tax, which included formulary tax aspects, failed to comply with the strict requirements of the 1983 final regulations.[101]

The Fifth Circuit in *Entergy v. Commissioner*[102] held that this same U.K. windfall profits tax was entitled to U.S. foreign tax credit relief,[103] thus creating a split in the circuits. In its evaluation of the Third Circuit's plain textual reading of the 1983 final regulations, the Fifth Circuit in *Entergy*[104] stated that the Third Circuit's denial of foreign tax credit relief exalted "form-over-substance."[105] The Supreme Court granted certiorari in *PPL Corp. v. Commissioner* to resolve the circuit split.[106]

The facts set forth in the *PPL* case put squarely at issue whether the formalistic predominant character standard would deny foreign tax credit relief to a non-dual-capacity taxpayer who paid a formulary tax that would have been entitled to relief under pre-1983 case law. The Supreme Court *unanimously* held that the U.K. windfall profits tax was entitled to U.S. foreign tax credit relief, thus reversing the Third Circuit's decision and affirming the Tax Court's original decision. But, in the course of its opinion, the Court omitted any detailed discussion of the mandatory formalistic predominant character test set forth in the 1983 final regulations. Instead of discussing how the 1983 final regulations had attempted to impose a

101. *See PPL Corp.*, 665 F.3d at 67 n.3.

102. *Entergy*, 683 F.3d at 233.

103. *Id.* at 239.

104. *Id.*

105. *Id.* at 237. The Fifth Circuit explained its disagreement with the Third Circuit's analysis as follows: "In fact, as the record indicates, each utility could only be subject to the Windfall Tax after making a profit exceeding approximately an 11% annual return on its initial flotation value, and the Windfall Tax liability increased linearly with additional profits past that point. Moreover, the Third Circuit opinion seems to overlook that a tax based on actual financial profits in the U.K. sense necessarily begins with gross receipts, as, again, the record here indicates. London Electricity's profit for purpose of the Windfall Tax was calculated by computing gross receipts less operating expenses. The Windfall Tax was designed to reach a subset of this leftover amount by beginning with an amount predicated on actual gross receipts minus flotation value." *Id.* at 233 (internal italics omitted). In affirming the Tax Court's allowance of foreign tax credit relief to the taxpayer in *Entergy v. Commissioner*, the Fifth Circuit reformulated the U.K. windfall profits tax into an economically equivalent formulation that (as reformulated) did meet the three formal design features of the 1983 final regulations. *See id.* at 238–39.

106. *See PPL Corp.*, 133 S. Ct. 1897.

formalistic approach, the Court attempted to harmonize the predominant character standard contained in the 1983 final regulations with the pre-1983 case law, stating that Regulation section 1.901-2(b) "codifies longstanding doctrine dating back to *Biddle*."[107] The Court omitted any serious discussion of the government's assertion that its formalistic predominant character standard was intended to bring "structure and clarity" not found in the earlier case law.[108]

As to the argument that the 1983 final regulations established a set of requirements that must be met in form,[109] the Court stated that this notion could not be squared with the black-letter principle that "tax laws deal in economic realities, not legal abstractions."[110] The Supreme Court eschewed any effort to apply the formal requirements of the predominant character standard set forth in the 1983 final regulations and instead used a holistic analysis reminiscent of the pre-1983 case law. In doing so, the Court opined that substance over form principles compel a conclusion "that the

107. *See id.* at 1901.

108. *Compare id.* at 1905 (where Court discusses portions of the government brief dealing with pre-1983 case law), *with* Brief for Respondent at 33–43, PPL v. Comm'r, 133 S. Ct. 1897 (2013) (No. 12-43) (where the government asserts that the formalistic three-pronged test set forth in the 1983 Treasury regulations is entitled to deference under Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704 (2011)). The government's argument was more robust in its brief before the Third Circuit and the Fifth Circuit as the following excerpt from its briefs in those proceedings so indicates: "[T]he Tax Court was required to accord the regulation *Chevron* deference. *See Mayo Found.*, 131 S. Ct. 704. Moreover, "because § 901's exemption from taxation is 'a privilege extended by legislative grace'" the regulation had to be "strictly construed." Texasgulf, Inc. v. Comm'r, 172 F.3d 209, 214 (2d Cir. 1999) (quoting Inland Steel Co. v. United States, 677 F.2d 72, 79 (Ct. Cl. 1982)). Instead, the Tax Court paid only lip service to the regulation. Although it discussed the regulation in summarizing the relevant legal principles (JA27-29), the court went on to apply its own test for determining the predominant character of the windfall tax. Thus, the court considered at length the historical background and purpose of the windfall tax and its effect on the companies subject to the tax. It made no effort whatsoever to explain whether the windfall tax met any of the three regulatory subtests, all of which had to be met for the tax to be creditable." *Compare* Brief for Appellant at 24, Entergy v. Comm'r, 683 F.3d 233 (5th Cir. 2012) (No. 10-60988) *with* Brief for Appellant at 21–22, PPL Corp. v. Comm'r, 665 F.3d 60 (3d Cir. 2011) (No. 11-1069).

109. *See* PPL Corp. v. Comm'r, 135 T.C. 304, 330 (2010) ("Respondent argues that the 1983 regulations alone control the creditability of the windfall tax because those regulations subsume or supersede prior caselaw and 'neither require nor permit inquiry into the purpose underlying the enactment of a foreign tax or the history of a foreign taxing statute.'").

110. *PPL Corp.*, 133 S. Ct. at 1905.

windfall [profits] tax is [best viewed as] nothing more than a tax on actual profits above a threshold."[111]

Admittedly, the formalistic predominant character test set forth in the 1983 final regulations would have created an incoherent result if applied to deny foreign tax credit relief to PPL as PPL was not the intended target of these technical rules. Nevertheless, by not resolving the *PPL* case within the formal guidelines of the predominant character test and failing to discuss the fact that the 1983 final regulations attempted to impose a formalistic set of requirements in lieu of the more holistic approach used in the pre-1983 case law, the Supreme Court cast considerable doubt on the continued validity of the 1983 final regulation's mandatory formalistic predominant character standard. Said differently, the Supreme Court's revisionist history undermines the formalistic predominant character standard set forth in the 1983 Treasury regulation. It places a heavy judicial gloss over those regulations to harmonize them with "longstanding doctrine dating back to *Biddle*"[112] when in fact the 1983 final regulations attempted to impose formality to the foreign tax credit eligibility analysis in order to provide "structure and clarity" not found in the prior case law.[113]

3. Indopco*'s damage to the formalistic predominant character standard*

The Supreme Court's decision in *PPL* did serious damage to the plain meaning of the 1983 final regulations. The decision ignored the intended plain meaning of the 1983 final regulations and instead harmonized those 1983 final regulations with pre-1983 case law. The *PPL* decision, by itself, provides a sufficient reason for the Treasury Department to rewrite its existing section 901 regulations to provide a coherent standard for determining foreign tax credit eligibility using standards that are consistent with the Supreme Court's holistic approach that harkens back to the pre-1983 case law. However, as discussed in this Section and the next, there are two other compelling reasons for the Treasury Department to open a

111. *Id.*

112. *See id.* at 1901, 1905 (stating that the regulations codify longstanding doctrine dating back to *Biddle* and then use "substance over form" principles to resolve the case).

113. *See supra* note 96.

regulatory project to rewrite the foreign tax credit eligibility standards contained in Regulation section 1.901-2(b).

First, the regulatory predominant character standard fails to reflect the evolution in the U.S. income tax laws that has occurred since 1983 and consequently utilizes standards that no longer accurately identify an income tax in the U.S. sense. Second, the Internal Revenue Service, through its published guidance, has repeatedly ignored its own 1983 regulations in determining the eligibility of recent formulary-type tax regimes of other countries. Thus, because the Supreme Court refuses to apply the intended plain meaning of the 1983 regulations and because those regulations fail to properly describe the evolution of the U.S. income tax law that has occurred since their promulgation and because the IRS ignores the regulations it is charged with implementing (creating a de facto administrative law at variance with published regulations), the United States' foreign tax credit regime is incoherent and needs reformulation.

As a beginning point of the analysis in this Section, the conclusion from Section II.A.1 must be kept in mind, namely that the 1983 final regulations posit that an income tax in the U.S. sense *must allow* for a recovery of *all* significant business expenditures (or their economic equivalent) in some reasonable period.[114] However, contrary to the 1983 final regulation's requirement that all significant business expenditures (or an equivalent amount) must be recoverable as an essential feature of an income tax in the U.S. sense, the IRS argued in 1992 in *Indopco v. Commissioner*[115] for the exact opposite position in a domestic tax context. In fact, the government in *Indopco* contended that allowing recovery for expenses was simply a matter of legislative grace and not an essential design feature of an income tax in the U.S. sense.[116] Nowhere in the government's *Indopco* briefs did it mention that it had a final section 901 regulation (entitled to *Chevron* deference) that estopped the government from arguing that the deductibility of all valid business expenditures was necessary to correctly reflect taxpayer income and an essential feature of the U.S. income tax laws. No, the government

114. *See* text accompanying notes 44–55.

115. Indopco v. Comm'r, 503 U.S. 79 (1992).

116. Brief for Respondent at 30–31, Indopco v. Comm'r, 503 U.S. 79 (1991) (No. 90-1278).

in *Indopco* urged the Supreme Court to disallow cost recovery for expenses if those expenses provided a future benefit even when no separate and distinct asset was created that could allow for future cost recovery.[117] In contrast, the taxpayer in *Indopco* urged the Supreme Court not to require capitalization unless a separate and distinct asset was created because capitalization without cost recovery failed to clearly reflect the taxpayer's income.[118]

117. It is important to note how many times the government states that there are "many" instances where significant expenses are not allowed for recovery under the U.S. income tax laws as of 1992: "If an expenditure produces a permanent or long-term benefit to the taxpayer that will help generate income in future years, it hardly would reflect the taxpayer's income to allow a current deduction for the expenditure merely because the benefit or advantage cannot readily be described as creating or enhancing an 'asset.' Indeed, the situation presented in this case provides a perfect example of the inadequacy of petitioner's 'separate and distinct asset' test. Petitioner does not challenge the findings of the Tax Court (Pet. App. 30a) and the court of appeals (Pet. App. 12a) that the takeover transaction resulted in permanent benefits for petitioner. Application of the test urged by petitioner-under which outlays may be deducted in one year even though the benefits of the expense are reaped for many years in the future-would result in a distortion of petitioner's income. For this reason alone, petitioner's test should be rejected. The courts have recognized *many* types of capital expenses that do not create or enhance any specific asset. Most relevant are the "changed corporate structure" cases discussed in Section II.A.1. In these cases, as then-Judge Blackmun noted in General Bancshares, 326 F.2d at 716, even when the reorganization expenses 'have not resulted in the acquisition or increase of a corporate asset, [they are treated as capital charges and] are not, because of that fact, deductible as ordinary and necessary business expenses.' Similarly, in Holeproof Hosiery Co. v. Commissioner, 11 B.T.A. 547 (1928), which was cited in General Bancshares, the court observed that 'it can be argued, and not without merit, that no capital asset is acquired when attorneys' fees are paid in connection with an increase in capitalization, but it does not follow that the payments are ordinary and necessary expenses of the year when made.' 11 B.T.A. at 556. The mere fact that a corporation's structure is not a 'separate and distinct asset' does not mean that expenses incurred to alter its structure for the permanent betterment of the corporation are not capital in nature. There are *many other examples* of business expenditures that have long been recognized as capital in nature even though they do not create or enhance any specific asset. The cost of an educational program that qualifies the taxpayer to enter a new trade or business is a non-deductible capital expenditure." *See* Brief for Respondent at 30–31, Indopco v. Comm'r, 503 U.S. 79 (1992) (No. 90-1278) (emphasis added).

118. Consistent with the government's argument in *PPL Corp. v. Comm'r*, the taxpayer in *Indopco* argued that the Supreme Court must ensure that significant business expenditures must be recoverable over some period as indicated in the following statement from the taxpayer's brief:

> Moreover, by requiring the identification of a specific asset to which capitalized costs are to be assigned, the Lincoln Savings test serves the clear reflection of income principle that underlies the statutory scheme-it permits such costs to be depreciated or amortized over the useful life of the asset and to be recovered upon its sale or other disposition. In contrast, the court of appeals' future benefit approach does not give taxpayers any means of recovering their capitalized costs. Where there is a future benefit but no asset to which capitalized costs can be

In a strongly worded and staunchly pro-government opinion, the Supreme Court stated that an income tax in the U.S. sense means gross income and that the allowance of deductions is purely a matter of legislative grace. The following extended excerpt from the *Indopco* case is relevant for understanding the nature of the U.S. income tax system as now understood and interpreted by the Supreme Court:

> In exploring the relationship between deductions and capital expenditures, this Court has noted the "familiar rule" that "an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a "complete list of nondeductible expenditures," serves as a general means of distinguishing capital expenditures from current expenses. For these reasons, deductions are strictly construed and allowed only "as there is a clear provision therefor."[119]

Even if one views the Supreme Court's statement that deductions are given simply as a matter of legislative grace as hyperbole, no one could avoid seeing that the Supreme Court's opinion in *Indopco* went out of its way to harken back to case law dating back to its 1934 holding that Congress has the unquestioned "power to condition, limit, or deny deductions from gross income in order to arrive at the net that it chooses to tax."[120]

Indopco also makes clear that the Court would not entertain criticism of Congress's refusal to allow cost recovery for a significant business expenditure. Consequently, post-*Indopco*, the net income test set forth in the 1983 final regulations is at variance with what the government argued was the essential design feature of an income

> assigned, the taxpayer will not be allowed any depreciation or amortization deductions or any deductible loss prior to the sale or abandonment of its entire business. Thus, the future benefit approach, by thwarting any recovery of capitalized costs during the period in which the taxpayer is operating its business and earning the income generated by those costs, defeats a clear reflection of income.

Brief for Petitioner at 13, Indopco v. Comm'r, 503 U.S. 79 (1992) (No. 90-1278).

119. *Indopco,* 503 U.S. at 84 n.4 (citations omitted; footnote omitted).

120. Helvering v. Indep. Life Ins. Co., 292 U.S. 371, 381 (1934).

tax in the U.S. sense. In 1992, the government told the Court in *Indopco* that there are *"many . . . examples"*[121] under U.S. tax law of business-related expenditures that do not create deductible expenses and never provide cost recovery.[122] Yet when judging a foreign country's tax levy, the predominant character standard in the 1983 final regulations mandates that *all significant* expenses must be entitled to cost recovery in order for foreign levy to be considered an income tax "in the U.S. sense."[123] The insistence by Regulation section 1.901-2(b) that all significant costs must be recoverable in the foreign country's tax regime is diametrically opposed to what the government asserted in *Indopco* about our own income tax regime.

The Supreme Court's opinion in *Indopco* also endorsed the government's view that allowing deductions was a matter of legislative grace and not a requirement for a tax levy to be considered an income tax in the U.S. sense. Thus, the requirement in the 1983 final regulations that cost recovery must be given for *all* significant expenses may have represented a reasonable interpretation of the U.S. case law in 1983, but that interpretation is no longer reasonable in 2016 because of the Supreme Court's intervening 1992 decision in *Indopco*. The net income test in the 1983 final regulations has been eroded, and the government was the one that argued for its erosion. In short, the government persuaded the Supreme Court to hold that significant expenses need not be allowed cost recovery in order to clearly reflect income under the U.S. income tax laws in *Indopco*. As a result, it is fundamentally inconsistent for the government to now argue that cost recovery for all significant expenses is a necessary feature for foreign levies to represent an income tax in the U.S. sense.

To compound the judicial erosion of the net income requirement, Congress has enacted significant disallowance rules, further demonstrating the inaccuracies of the 1983 final regulations' assertion that *all* significant expenses must be allowed cost

121. *See supra* note 102 (emphasis added).

122. *See* Brief for Respondent at 30–31, Indopco v. Comm'r, 503 U.S. 79 (1992) (No. 90-1278).

123. This is the standard in the existing Treasury regulations that require the predominant character of a foreign levy must be an income tax in the US sense. *See* Treas. Reg. § 1.901-2(a)(ii) (as amended 2013).

recovery.[124] In this regard, Congress has outright denied deductions related to illegal activities,[125] bribes, and kickbacks,[126] implemented extensive restrictions on the ability to utilize passive losses,[127] expanded the scope of the at-risk rules to limit deductions,[128] partially disallowed entertainment expenses,[129] disallowed certain salary expenses,[130] and has outright disallowed certain cross-border interest expense deductions.[131] Some of these reforms occurred before the 1983 final regulations were issued while others occurred after the issuance of the 1983 final regulations. Taken as a whole, these reforms demonstrate that U.S. tax law has not required that all significant expenses must be afforded cost recovery; rather, Congress has chosen to significantly limit or disallow a tax deduction for a whole range of business expenses in order to ensure that it can tax the net income in which it wants to tax.[132]

With respect to all of these disallowance and limitation regimes, the courts have allowed Congress discretion to define the net income that Congress chooses to tax, regardless of whether or not all significant ordinary and necessary expenses are allowed as a deduction. Consequently, disallowing foreign tax credit relief when a foreign country incorporates formulary or presumptive tax principles is unsupportable given the intervening Supreme Court opinion in *Indopco* and given Congress' continuing actions to disallow cost recovery when it wants to restrict tax benefits for some larger policy reason. Once the Supreme Court in *Indopco* gave a full-throated endorsement to Congress's "power to condition, limit, or deny

124. For an analysis of the intended plain meaning of the 1983 final regulations, see the discussion set forth in Section II.A.1.

125. I.R.C. § 280E (1982); *see* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 351(a), 96 Stat. 324, 640 (1982).

126. I.R.C. § 162(c); Tax Reform Act of 1969, Pub. L. No. 91-172, § 902(b), 83 Stat. 487, 710–11.

127. I.R.C. § 469; Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 100 Stat. 2085, 2233 (1986).

128. I.R.C. § 465; Tax Reform Act of 1976, Pub. L. No. 94-455, § 204(a), 90 Stat. 1520, 1531–33 (1976).

129. I.R.C. § 274(n); Tax Reform Act of 1986, § 142(b).

130. I.R.C. § 162(m); Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13211(a), 107 Stat. 312, 469–71 (1993).

131. I.R.C. § 163(j); Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7210(b)(2), 103 Stat. 2106, 2147 (1989).

132. *See* Section II.A.1.

deductions from gross income in order to arrive at the net that it chooses to tax,"[133] the 1983 final regulations became obsolete to the extent that they require foreign tax levies to allow all significant deductions in order to be considered an income tax in the U.S. sense.

4. BEPS challenge to the foreign tax credit regime

The incoherence of the formalistic predominant character standard set forth in Regulation section 1.901-2(b) becomes clearer when considering how this standard interacts with the international tax policy decisions of other nations. In this regard, it is important to keep in mind that today's challenge for developed nations is to defend their tax base against profit shifting and base erosion strategies of multinational enterprises.[134] The G20[135] and the G-8[136] have each expressed concern over how countries should prevent the artificial shifting of profits to low tax jurisdictions. The OECD has engaged in a multi-year study[137] designed to provide recommendations on how countries should address this profit-shifting phenomenon (the so-called "base erosion and profit shifting" or "BEPS" project). Source countries are actively designing tax base defense mechanisms to supplement their income tax collection efforts.[138]

As source countries attempt to defend their tax base from artificial shifting of income out of their tax base and into low tax jurisdictions, scholars have increasingly argued that formulary apportionment principles will be required to prevent artificial profits-

133. Helvering v. Indep. Life Ins. Co., 292 U.S. 371, 381 (1934).

134. *See* Bret Wells, *"Territorial" Tax Reform: Homeless Income is the Achilles Heel,* 12 Hous. B. & Tax L.J. 1, 39 (2012).

135. G20, G20 Leaders Declaration, at ¶48, G20 at Los Cabos, Mexico (June 18–19, 2012), https://www.g20.org/sites/default/files/g20_resources/library/G20_Leaders_Declaration_Final_Los_Cabos.pdf.

136. Prime Minister's Office & Cabinet Office, *G8 factsheet: tax (html)*, GOV.UK (June 7, 2013), https://www.gov.uk/government/publications/g8-factsheet-tax/g8-factsheet-tax.

137. The OECD has established a website to organize the various reports, press releases, and conference calls, and other activities related to its base erosion and profit shifting initiative at http://www.oecd.org/ctp/beps.htm. A discussion of the BEPS project is beyond the scope of this article, but for further study, see Yariv Brauner, *What the BEPS?*, 16 FLA. TAX REV. 55 (2014).

138. *See* Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin,* 965 TAX L. REV. 535, 599–602 (2012).

shifting through intercompany arrangements.[139] Thus, it is foreseeable that countries will increasingly disregard intercompany transfer pricing agreements and instead choose to exercise their "power to condition, limit, or deny deductions from gross income in order to arrive at the net that it chooses to tax"[140] to prevent an inappropriate erosion of their corporate tax base at the hands of profit-shifting strategies of multinational enterprises.

The introduction of such tax base protection limitations creates uniquely complex U.S. foreign tax credit issues under the 1983 final regulations.[141] This foreseeable evolution poses no significant impact to multinational enterprises incorporated in jurisdictions that do not attempt to tax extra-territorial business income. But, the thesis of this Article is that the United States will continue to assert residency-based worldwide taxation (either on a current or deferred basis) on the extra-territorial income earned by U.S. multinational enterprises, and as a result, the design challenge for the U.S. government is to ensure that its foreign tax credit regime is flexible enough to provide coherent foreign tax credit relief in the midst of these foreseeable BEPS responses.

International double income taxation should be avoided except to the extent that denial of foreign tax credit relief represents a necessary attack on objectionable foreign tax credit transactions. The formalistic predominant character standard was designed as a duplicative attack on yesterday's disguised oil royalty problem, but these backward looking regulations are ill-suited for the challenging foreign tax credit issues of today. The continued existence of the formalistic predominant character standard set forth in the 1983 final regulations creates unnecessary risks of international double income taxation without a compelling policy reason for doing so (in fact, there is a compelling policy reason based on competitiveness reasons to minimize unnecessary international double income taxation).

139. *See* Reuven Avi-Yonah & Ilan Benshalom, *Formulary Apportionment—Myths and Prospects*, 2011 WORLD TAX J. 371 (2011); Reuven Avi-Yonah, Kimberly Clausing & Michael Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497 (2009).

140. Helvering v. Indep. Life Ins. Co., 292 U.S. 371, 381 (1934).

141. *See* Reuven Avi-Yonah, *Should the U.S. Dictate World Tax Policy? Reflections on* PPL Corporation v. Commissioner, 138 TAX NOTES INT'L 871 (2013).

For example, if a country were to adopt a separate thin capitalization regime as an alternative minimum tax regime, the "separate levy rule" would require this separate foreign levy to be individually tested to determine whether this component part of the income tax law is considered to be an income tax in the U.S. sense. In prior temporary regulations, the Treasury Department had provided a comforting example that had favorably dealt with thin capitalization regimes,[142] but this example was deleted from the 1983 final regulations.[143] Instead of providing guidance in this situation, the 1983 final regulations state in conclusory fashion that a foreign tax levy be considered an income tax only in rare circumstances when such levy disallows significant expenses. The regulations also state that if significant expenses are disallowed, it must be shown that the foreign levy will nevertheless be "almost certain to reach some net gain" notwithstanding the expense disallowance aspects of the foreign tax levy.[144] Thus, a tax on gross receipts or on gross income satisfies the net income test only if all significant expenses are deductible or if the foreign levy is "*almost certain* to reach *some* net gain."[145] Now that the United States has its own form of thin capitalization regime,[146] one would hope that a plain textual interpretation of the net income test set forth in the 1983 final regulations would not cause a foreign thin capitalization regime to fail the net income test. However, the 1983 final regulations are purposely silent on this point.[147]

The availability of U.S. foreign tax credit relief, however, becomes more doubtful under a plain textual reading of the 1983 final regulations if the foreign country adopts an alternative minimum asset tax regime in lieu of disallowing related party expenses via a "thin capitalization" regime. In this regard, many

142. Temp. Treas. Reg. §4.901-2(e), Ex. (24) (1980).

143. In the preamble to the final regulations, the Treasury Department explained this deletion on the grounds that the government wanted to "avoid the possible implication that a tax that disallowed additional deductions [beyond those set forth in the example] would not meet the net income test," but it would have been much preferred if the regulations would have retained this example and given a further clarifying statement about how foreign country base protecting measures would be analyzed under these rules. *See* T.D. 7918, 1983-2 C.B. 113.

144. *See* Treas. Reg. § 1.901-2(e)(4), (b)(4).

145. Treas. Reg. § 1.901-2(b)(4)(i)(B) (emphasis added).

146. *See* § 163(j).

147. *See* Treas. Reg § 1.901-2.

Latin American countries have relied on alternative minimum asset tax regimes to backstop their broad-based general income tax regime.[148] These countries have viewed asset tax regimes as a necessary anti-abuse measure to protect against base erosion from aggressive inbound tax planning.[149] Asset taxes generally range from 0.2% to 2% and indirectly represent a limit on thinly capitalized companies.[150] Some form of asset tax has been enacted in Argentina, Bolivia, Costa Rica, Colombia, Ecuador, Guatemala, Honduras, Mexico, Nicaragua, Peru, and Venezuela.[151] Further, in order to identify a taxpayer's net assets, for example, Mexico allows taxpayers to reduce their net assets by the amount of debt that was payable to other Mexican non-financial institutions, but does not allow deduction for cross-border related-party debt.[152] Again, Mexico is attempting to defend its income tax base against base erosion strategies.[153]

Prior to the 1983 final regulations, a business asset tax enacted to complement a country's collection of its general income taxes would probably have been viewed as a creditable foreign tax under prior authority.[154] In fact, the Argentine government adopted its business asset tax only after it received assurance from the International Monetary Fund ("IMF") that the Argentine asset tax would be creditable in the United States.[155] The Argentine

148. Argentina, 1995 Income and Capital Tax Convention and Final Protocol, Argentina-Denmark, art. 30, Sep. 4, 1997 96 TNI 234–34, Chile, Phillip R. West, *Across the Great Divide: A Centrist Tax Reform Proposal,* 130 TAX NOTES 1025, 1033 (Feb. 28, 2011), and Peru, William J. Gibbons, *Tax Effects of Basing International Business Abroad,* 69 HARV. L. REV. 1206, 1249 (1956), have all enacted thin capitalization rules. Thus, perhaps the trend to use a limitation on interest expense deductions will be a growing trend in Latin America as well.

149. *See, e.g., For Argentina,* Dictamen D.A.L. 55/99 (25 June 1999). The theory for an asset tax is that a business asset should generate at least a minimum level amount of income (a return on asset) over a reasonable period of time. If this is not the case and the business is continued, then the assumption must be that there is unreported income. *See* Bret Wells, *Tax-Effective Methods to Finance Latin American Operations,* 28 INT'L TAX J. 21 (2002).

150. *See* John McLees, *The Business Asset Tax*, 93 TAXES NOTES TODAY 175-24 (Sept. 10, 1993).

151. *See, e.g.*, *id*.

152. *Id*.

153. *Id*.

154. *See* Rev. Rul. 67-329, 1967-2 C.B. 257; *see also* Rev. Rul. 73-117, 1973-1 C.B. 344; Rev. Rul. 78-62, 1978-1 C.B. 226.

155. Stephen Hodge, *Argentine Tax On Minimum Presumed Income, U.S. Foreign Tax Credit Out of Sync*, 2001 TAX NOTES TODAY 85-39.

government was later surprised to find out that the IMF's assurances that the Argentine asset tax would be entitled to U.S. foreign tax credit relief were incorrect.[156] With the notable exception of the United States, a survey of existing worldwide tax treaties reveals a broad international consensus that asset tax regimes implemented as part of the overall general income taxes of a foreign country should be eligible for foreign tax credit relief under bilateral income tax treaties around the world.[157]

156. *Id.*

157. This is recognized explicitly in many treaties. The Argentina-Spain Tax Treaty Art. 2(3)(b) and Art. 23(1), Mar. 11, 2013, 69 TNI 1128, Doc. 2013-6458; Mexico-Chile Tax Treaty Art. 2(3)(b)(ii) and Art. 23(1)(1). Agreement between the United Mexican States and the Republic of Chile for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital (with protocol), Mex.-Chile, Apr. 17, 1998, 2484 U.N.T.S. 350; Convention Between the Republic of Venezuela and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, Switz.-Venez., art. 2(3)(b)(ii) & 23, Dec. 23, 1997, 2235 U.N.T.S. 39782 (325); Convention Between the Kingdom of Norway and the Republic of Venezuela for the Avoidance of Double Taxation and the Prevention of Fiscal Avoidance and Evasion with Respect to Taxes on Income and on Capital, Nor.-Venez., art. 2(3)(a)(ii) & 24(2)(a), Oct. 29, 1997, 98 TNI 23-25; Doc 98-4933; Mexico-Denmark Tax Treaty Art. 2(3)(a)(ii) and Art. 24(2). Convention between the United Mexican States and the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Mex-Den., Jun. 11, 1997, 97 TNI 217-19, Doc 97-30474; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion and Avoidance with Respect to Taxes on Income Between the Republic of Indonesia and the Republic of Venezuela, Indon.-Venez., art. 2(3)(a) & 23(2), Feb. 27, 1997, 2000 WTD 16-35; Doc. 1999-39606; The Finland- Mexico Tax Treaty Art. 2(3)(a)(ii) and Art. 22(2)(a). Agreement between the Republic of Finland and the united Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Fin.-Mex., Feb. 12, 1997, 2124 U.N.T.S. 295; The Mexico-Venezuela Tax Treaty Art. 2(3) and Art. 22(3). Convention Between the Republic of Venezuela and the United States of Mexico for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mex.-Venez., Feb. 6, 1997, 97 TNI 172-22; Doc 97-24843 (states asset taxes of both countries are considered income taxes); Convention Between the Government of the Republic of Venezuela and the Government of the Republic of Trinidad and Tobago for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion and Avoidance with Respect to Taxes on Income and for the Encouragement of International Trade and Investment (with protocol), Trin. & Tobago-Venez., art. 2(3)(b) & 23(1), July 31, 1996, 2407 U.N.T.S. 43447 (3); The Venezuela-Czech Republic Tax Treaty Art. 2(3)(b)(ii) and Art. 23(2), April 26, 1996, Doc. 96-30053, 96 TNI 227-29; The Mexico-Italy Tax Treaty Art. 2(3)(a) and Art. 22(2). Convention between the United Mexican States and the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion, Mex.-It., July 8, 1991, 97 TNI 109-27; Doc 97-16427; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains (with exchange of notes), U.K.-Venez., art. 2(1)(b)(ii) & 22(1)(a), Mar. 11, 1996, 1972 U.N.T.S. 33711 (141); Art. 2(3)(b)(ii) and Art. 23(4) of the Argentina-United Kingdom Tax Treaty; Art. 2(3)(b) (January 3, 1996, 93 TNI

Even though out-of-step with international norms, the IRS has ruled that the "separate levy rule" requires an asset tax to be separately tested.[158] When so tested under the formalistic predominant character standard set forth in the 1983 final regulations, such levies fail to qualify for U.S. foreign tax credit relief because they fail to meet the realization test, the gross receipts test, and the net income test.[159] Given the broad international consensus that foreign tax credit relief should be available for alternative minimum taxes such as asset taxes, the fundamental question is: what is the U.S. tax policy justification for this incoherent divergence from this international consensus, particularly when the disallowance of U.S. foreign tax credit relief subjects U.S. taxpayers to prejudicial double international income taxation even though no "disguised royalty problem" is implicated?

251-52, Doc. 96-31575); The Mexico-Norway Tax Treaty Art. 2(3)(a)(ii) and Art. 24(8). Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Mex.-Nor., Mar. 23, 1995, 1947 U.N.T.S. 166; The Argentina-Denmark Tax Treaty, Art. 2(3)(b)(ii) and Art. 24(2), December 12, 1995, 96 TNI 234-34, Doc 96-31248; See The Argentina-Canada Tax Treaty, Art. 2(3)(b)(ii) and Art. 23(1)(a), Dec. 30, 1994, 2027 UNTS 407; The Argentina-Finland Tax Treaty Art. 2(3)(b) and Art. 23(1)(a)(ii), December 13, 1994, 96 TNI 30-25; Doc 96-2267; The South Korea-Mexico Tax Treaty Art. 2(3)(a)(ii) and Art. 23(4). Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (with protocol), S. Kor.-Mex., Oct. 6, 1994, 1873 U.N.T.S. 139; The Netherlands-Mexico Tax Treaty Art. 2(1)(b) and Art. 22(2). Agreement between the Kingdom of the Netherlands and the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (with protocol), Neth.-Mex., Sept. 27, 1993, 2217 U.N.T.S. 105; The Mexico-Germany Tax Treaty Art. 2(3)(a) and Art. 23(2)(b). Agreement for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital (with protocol), Mex.-Ger., Feb. 23, 1993, 1764 U.N.T.S. 204; The Mexico-Sweden Tax Treaty Art. 2(1)(a)(ii) and Art. 22(3). Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (with protocol), Mex.-Swed., Sept. 21, 1992, 1719 U.N.T.S. 407; The Spain-Mexico Tax Treaty Art. 2(3)(b) and Art. 23(1). Convention for the Avoidance of Double Taxation and the Prevention of Fraud and Fiscal Evasion with Respect to Taxes on Income and Capital (with protocol), Spain-Mex., Jul. 24, 1992, 1832 U.N.T.S. 179; The Mexico-France Tax Treaty Art. 2(2)(b)(ii) and Art. 21(1)(a). Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Mex.-Fr., Nov. 7, 1991, 1719 U.N.T.S. 330; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (with protocol), Can.-Mex. Art. 22(1), Apr. 8, 1991, 1883 U.N.T.S. 350 (349).

158. *See* Rev. Rul. 91-45, 1991-2 C.B.336.

159. *Id*. Admittedly, Rev. Rul. 91-45 would allow § 901 relief to apply if the Mexican asset tax payments were refunded and regular income tax payments were later made, but this requires the foreign country to carefully craft its asset tax laws; other Latin American countries with similar asset taxes have not done so, and it is difficult to articulate why they should.

Another tax base protection device that source countries have enacted specifically for inbound activities are presumptive tax regimes. Under a presumptive tax regime, a tax is paid on certain categories of transactions based on turn-over, gross revenue,[160] or on net capital gains. Source countries have found it difficult to collect taxes from offshore investors. In response, several countries have implemented presumptive tax regimes that impose a reduced tax rate on the net capital gain or on the gross turnover of a particular activity as a minimum income tax regime while still retaining their general income tax regimes. Again, these alternative minimum tax regimes deal with the practical difficulty of preserving to the source country a practical means of collecting the expected "right amount" of income tax while avoiding intractable cross-border transfer pricing controversies.

Early case law and IRS rulings were supportive of such "backstop" regimes and generally held that the taxes paid under such alternative minimum tax regimes would be entitled to U.S. foreign tax credit relief if they were part of the country's general income tax laws and designed to "backstop" the effective collection of the general income tax of the country.[161] In contrast to the holistic overall approach utilized in prior case law, the "separate levy rule" coupled with the three-pronged "predominant character standard" set forth in the 1983 final regulations requires that these complimentary regimes be separately tested to determine their eligibility. When so tested, these minimum tax regimes may fail the formal design requirements of the three-pronged "predominant character standard."[162] Even though the intent of such "backstop"

160. Because cross-border transfer pricing compliance is difficult, Brazil has instituted a regime that presumes that all related-party exports have at least a presumptive profit margin and the tax on this presumptive margin is required to be paid. *See* Yoon Chung Kim and Sonia Zapata, *Taxation in Latin America: Brazil* ¶ 5.11(e) (IBFD 2001). This regime attempts to deal with the base erosion opportunities through a collection mechanism designed to "backstop" the country's general income tax laws. In some cases, the "in lieu" provisions of section 903 may be available to provide relief, but this is only the case where the presumptive tax regime is in complete substitution for (and not complimentary of) the generally applicable income tax regime. *See* § 903; Treas. Reg. § 1.903-1(b)(1) ("a foreign tax satisfies the substitution requirement if the tax in fact operates as a tax imposed in substitution for, ***and not in addition to***, an income tax").

161. I.R.S. Gen. Couns. Mem. 800 (1926); *see* Burk Bros. v. Comm'r of I.R.S., 20 B.T.A. 657, 661 (1930).

162. *See* Treas. Reg. § 1.901-2(b)(4)(i)(B) (2010); Rev. Rul. 76-215, 1976-1 C.B. 194; I.R.S. Gen. Couns. Mem. 38,087 (Sept. 12, 1979); I.R.S. Gen. Couns. Mem. 36,587 (Feb.

regimes is to collect the "expected right" amount of income tax in a way that defends against tax base erosions strategies, the three-part predominant character standard (if faithfully applied) leads to an incoherent conclusion. These presumptive tax regimes fail to meet the formalistic net income test set forth in the regulations and thus are ineligible for U.S. foreign tax credit relief except in the limited situation where the presumptive tax regime represents a complete substitution[163] (and not simply a complementary regime) for the foreign country's general income tax laws.

Perhaps the most significant indictment on the 1983 final regulations is the fact that the Internal Revenue Service has ignored these regulations in several recent rounds of guidance on innovative foreign formulary tax levies that were adopted as part of a foreign country's income tax laws.[164] In this regard, Mexico enacted a new tax in 2008 called the impuesto empresarial a tasa única (IETU) and repealed the IETU as of January 1, 2014. The main goal of this tax was to fight tax evasion with Mexico's underground economy by requiring companies that do a large amount of business in cash to pay a 2 percent tax (increased to 3 percent as of January 1, 2010) on the deposit of currency above MXN 25,000. The IETU's explicit goal was to stop tax evasion, so the tax did not target compliant taxpayers. The IETU was creditable against federal Mexican income tax. Because this tax did not allow deductions, tax scholars[165] and the tax practitioner community understood that this tax failed to meet

17, 1976); I.R.S. Tech. Adv. Mem. 95-32-003 (May 30, 1995); I.R.S. Tech. Adv. Mem. 97-13-001 (Apr. 26, 1995); I.R.S. Tech. Adv. Mem. 2003-31-001 (Apr. 1, 2003). The case law requires that in order for taxes paid under such complementary tax regimes to be eligible for U.S. foreign tax credit relief, such tax regimes must be likely to reach net gain. *See* Bank of Am. Nat'l Tr. & Sav. Ass'n v. United States, 459 F.2d 513 (Ct. Cl. 1972), *cert. denied*, 409 U.S. 949 (1972); Inland Steel Co. v. United States, 677 F.2d 72 (Ct. Cl. 1982). Simplified tax regimes have represented income taxes in the U.S. sense only when the courts were convinced that deductions were allowed that compensated for the non-deductibility of significant business expenses. *See* Exxon Corp. Comm'r, 113 T.C. 338, 1999 WL 98398 (1999); Texasgulf, Inc. v. Comm'r, 172 F.3d 209 (2d Cir. 1999), *aff'g* 107 T.C. 51 (1996).

163. Section 903 provides an alternative basis for foreign tax credit relief, but the "in lieu of" tax must be completely in lieu of any further application of the country's income tax laws. *See* Treas. Reg. § 1.903-1(b)(1).

164. See text accompanying notes 143–52.

165. *See* David Cameron, *PPL: Where's the Treaty Argument?*, 2013 WTD 44-11, Tax. Doc. 2013-2888 (Mar. 6, 2013).

the formalistic predominant character standard set forth in the 1983 final regulations.[166]

Instead of issuing a ruling that set forth this incoherent result, the IRS issued Notice 2008-3, 2008-1 C.B. 253, which instead provided an incoherent rationale. In this ruling, the Internal Revenue Service said that this tax needed "study" and that "the IRS will not challenge a taxpayer's position that the IETU is an income tax that is eligible for a credit." The Internal Revenue Service allowed interim creditability for the IETU without providing any coherent rationale for how this tax satisfied the three-part standard set forth in Regulation section 1.901-2(b). The reality was, and is, that the Internal Revenue Service simply did not want to apply its own overly formalistic section 901 regulations because doing so would create an incoherent outcome. However, to achieve this coherent result the IRS needed to issue a ruling that was devoid of any coherent rationale.

In 2010, Puerto Rico imposed a formulary excise tax on multinational enterprises operating in its borders Nevertheless, the Internal Revenue Service, instead of faithfully applying its existing 1983 final regulations and then applying the completely "in lieu of" standard of section 903, stated in Notice 2011-29, 2011-16 I.R.B. 663, that the provisions of this excise tax "were novel." Because this excise tax qualified as "novel," the Internal Revenue Service further stated that "pending resolution of these issues, the IRS will not challenge a taxpayer's position that the Excise Tax is a tax in lieu of an income tax." Thus, again, without any coherent explanation, the Internal Revenue Service stated that it would not challenge foreign tax credit eligibility even though it did not (and in this author's opinion could not)[167] articulate a coherent rationale for allowing credit relief. Because the existing foreign tax credit regulations (if faithfully followed) create incoherent outcomes, these existing regulations are ill-suited for the issues presented in today's era. As a consequence, the IRS is developing a *de* facto administrative law that is unsupported by existing regulations.

166. *See* Randall Jackson, *From the Archives: When Is a Foreign Tax Creditable in the U.S.?*, 2014 WTD 248-4, Tax. Doc. 2014-29957 (Dec. 29, 2014).

167. Others have reached the same conclusion. *See* Martin A. Sullivan, *Puerto Rico Shows Tax Policy at Its Best and Worst*, 77 TAX NOTES INT'L 467 (2015); Martin A. Sullivan, *Economic Analysis: The Treasury's Bailout of Puerto Rico,* 73 TAX NOTES INT'L 267 (2014).

In 2008, the United Kingdom imposed a fixed £30,000 levy on U.K. non-domiciliary taxpayers.[168] In Rev. Rul. 2011-19, 2011-36 I.R.B. 119, the Internal Revenue Service reached a coherent outcome by allowing this tax to be eligible for U.S. foreign tax credit relief. However, to reach this coherent outcome, the IRS made the assertion that this levy was likely to reach net income even though it was a fixed amount and did not provide any deductions. As the press had reported, this ruling cannot be reconciled with the existing three-part predominant character standard in Regulation section 1.901-2(b).[169] Even worse, the Internal Revenue Service does not try to articulate a coherent rationale for how to harmonize this allowance of foreign tax credit relief with the standards set forth in its regulatory regime.

On December 10, 2014, the United Kingdom published proposed legislation that would attempt to assert U.K. taxing jurisdiction over diverted profits, which the legislation defined as arrangements that erode the U.K. tax base.[170] The U.K. diverted profits tax applies when there is not a U.K. permanent establishment or when U.K. origin profits, under transfer pricing arrangements, are shifted to offshore entities that pay low amounts of tax and lack of economic substance in their country of residence.[171] This legislation became effective on April 1, 2015.[172]

This proposed diverted profits legislation is designed to protect the U.K. corporate tax base from base erosion and profit shifting techniques of multinational enterprises, but does so by disallowing some substantial business expenditures. Thus, this diverted profits legislation attempts to ensure that income taxes on net income derived in the United Kingdom are taxed in the United Kingdom, but this regime is unlikely to meet the formalistic predominant character standard in the 1983 final regulations because it does not guarantee that *all substantial* business expenses are entitled to cost

168. Notice 2011-29.

169. *See* Lee A. Sheppard, *Does the U.K. Diverted Profits Tax Qualify for the Foreign Tax Credit,* 146 TAX NOTES 159 (Jan. 12, 2015).

170. *See* HM Revenue & Customs, Overview of Legislation in Draft at 14 (Dec. 10, 2014), available at Tax. Doc. 2014-29148.

171. *Id.*

172. *Id.*

recovery.[173] But again, as the IRS has now repeatedly ignored its own regulations, it is uncertain what it will do with respect to this new measure. The U.K. diverted profits legislation is clearly aimed at defending the U.K. income tax base by "conditioning, limiting, or denying deductions from gross income in order to arrive at the net that [the U.K.] chooses to tax."[174] Recent news reports indicate that other countries are considering similar diverted profits measures to protect their income tax base from the BEPS phenomenon.[175] Viewed in its totality, these recent developments demonstrate that the formalistic predominant character standard set forth in the 1983 final regulations is ill-suited to address innovative legislation and thus poses a serious risk that U.S. multinational enterprises would be unable to obtain U.S. foreign tax credit relief.

Consequently this analysis underscore the current reality: the formalistic predominant character[176] standard in the 1983 final regulations is ill-suited for providing coherent outcomes given how other countries are designing their tax systems to address the BEPS phenomenon.

5. Final reassessment of the formalistic predominant character standard (not good)

For the reasons set forth in the preceding sections, the Treasury Department should amend Regulation section 1.901-2(b) to replace the predominate character standard with a more holistic approach that is consistent with the pre-1983 case law. The historic rationale for infusing formal requirements into the regulatory predominant character standard is adequately addressed by Regulation section

173. *See* Lee A. Sheppard, *Does the U.K. Diverted Profits Tax Qualify for the Foreign Tax Credit,* 146 TAX NOTES 159 (Jan. 12, 2015). *But see* Philip Wagman, *The U.K. Diverted Profits Tax: Selected U.S. Tax Considerations,* 147 TAX NOTES 1413 (June 22, 2015) (although recognizing that the law is unsettled, the author argues that "[i]t might be argued that the [U.K. diverted profits tax] authorization of recharacterizations in which related-party deductions are denied, in circumstances suggesting possible inappropriate base stripping, represents a reasonable limit on deductions for costs and expenses that is reasonable under the section 901 regulations").

174. *See* text accompanying note 133.

175. Mindy Herzfeld, *PEs and FTCs: Who Wins, Who Loses?*, 2015 WTD 80-1, Tax Doc. 2015-9705 (Apr. 27, 2015).

176. *See generally* Ryan Finley, *Treasury Undecided on Creditability of U.K. Diverted Profits Tax,* 2015 TNT 207-6, Tax. Doc. 2015-23734 (Oct. 27, 2015).

1.901-2A without the need for further complexity.[177] In addition, the Court's reinterpretation of the standard in the *PPL* case places a heavy judicial gloss on the 1983 final regulations to harmonize them with prior case law when, in fact, the intended plain meaning of the 1983 final regulations was to supplant the more holistic analysis of pre-1983 case law.[178] Moreover, the 1983 final regulations articulate a net income standard that is inconsistent with how the U.S. income tax laws have been characterized by the Supreme Court's *Indopco* decision where the Court stated that the taxpayer did not need to be afforded a deduction for all substantial expenditures in order to clearly reflect income in the U.S. sense.[179] And, worse yet, the Internal Revenue Service has issued public guidance that side-steps the need to apply the government's own regulations, thus creating an administrative working law that is incoherent, unexplained, and irreconcilable with the existing 1983 final regulations. Each of these examples points to an irreconcilable conflict: to achieve a "coherent outcome" in important fact patterns, Regulation section 1.901-2(b) cannot be applied in a "coherent manner" because this regulation (if literally applied) logically leads to incoherent and unjust outcomes.

It is now time for the Treasury Department to issue *new* regulatory guidance so that its section 901 regulations provide a standard that, when transparently applied, affords coherent foreign tax credit outcomes. The existing 1983 final regulations are inflexible, ignored by the government, and were reinterpreted by the Supreme Court in *PPL* in a "substance over form" manner to afford coherent outcomes. These regulations need to be revised to eliminate unnecessary uncertainty and unhelpful controversy. Regulation section 1.901-2(b) represents a look backwards to yesterday's disguised oil royalty problem when these regulations instead should be forward-looking to address the foreign tax credit eligibility standards that are appropriate for a world where formulary or presumptive tax protection measures are likely to be embedded within the country's income tax laws. Given that the United States needs its foreign tax credit regime to appropriately mesh with the

177. Professor Coven urged the Treasury Department to remove this requirement fifteen years ago, and the PPL decision only adds more force to that argument. *See* Coven, *supra* note 49, at 127.

178. For the rationale of these formalistic changes, see the discussion in Section II.A.1.

179. Indopco v. Comm'r, 503 U.S. 79 (1992).

foreign tax regimes of other nations, the Treasury Department should immediately open a regulatory project to rewrite Regulation section 1.901-2(b) so that the faithful application of the government's foreign tax credit regulations does not result in disallowing U.S. foreign tax credit relief for foreign income taxes that are paid in non-objectionable situations.

Because the Treasury Department redundantly solved the disguised oil royalty problem with its dual capacity taxpayer regulations contained in Regulation section 1.901-2A, the section 907 limitation regime also has become redundant as it tries to attack the already adequately addressed disguised oil royalty problem in another manner.[180] Therefore, Congress should repeal section 907 as its legitimate concerns have already been addressed by the Treasury Department through the issuance of the dual capacity taxpayer regulations of section 1.901-2A. The cross-crediting concerns raised by high extraction taxes needed a response, but generated three redundant responses. Now is the time to remove the needless complexity of the extra two responses, which include the formalistic aspects of the predominant character standard and the specialized section 907 limitation regime that applies to extraction taxes.

B. Blitzkrieg Against Compaq-Style Financial Arbitrage Transactions

In the 1990s, the government's war on objectionable foreign tax credit transactions moved away from extraction taxes and settled into a fight over the cross-crediting of excess foreign tax credits generated by abusive financial arbitrage transactions. In Notice 98-5, the government expressed strong hostility toward taxpayer attempts to cross-credit taxes generated in abusive financial arbitrage transactions and identified five transactions of interest to discuss the contours of its policy concerns.[181] The Treasury Department argued that each of the five transactions of interest set forth in Notice 98-5 lacked economic substance because they made no sense apart from their generation of U.S. foreign tax credit benefits. When a transaction only has an economic justification when considering the U.S. tax savings from excess U.S. foreign tax credits, then the transaction does not have a sufficient non-tax business purpose, at least

180. *See supra* note 46.
181. 1998-1 C.B. 334, withdrawn by Notice 2004-19, 2004-1 C.B. 606.

according to Notice 98-5. Again, the fundamental point is that the government signaled a willingness to restrict foreign tax credit eligibility standards as a means to attack the cross-crediting of excess credits generated from "objectionable transactions." Section 904, which was designed in 1921 to handle the cross-crediting phenomenon, was perceived as ill-suited for the abusive transaction of concern.

The formulation of the economic substance doctrine set forth in Notice 98-5 was challenged in *Compaq Computer v. Commissioner*.[182] Compaq had recognized a long-term capital gain of approximately $232 million.[183] Upon learning of this capital gain, an investment banker structured a series of financial transactions that allowed Compaq to purchase ten million Royal Dutch ADRs for approximately $887.6 million cum-dividend, and to sell these shares ex-dividend for approximately $868.4 million.[184] Compaq, using the "next-day" settlement rules, settled the purchase-trades on September 17, 1992.[185] However, for the sale-trades, Compaq used regular settlement rules and settled the sales-portion of the transaction on September 21, 1992.[186] As a result of the difference in settlement dates, Compaq was the owner of ten million Royal Dutch ADRs on the dividend record date of September 18 and thus was entitled to receive a dividend of approximately $22.5 million.[187] The Dutch withholding taxes on this dividend were approximately $3.4 million, so Compaq actually received a net dividend of $19.1 million.[188] Compaq also incurred transaction costs on the trades totaling $1.5 million.[189] Thus, the transaction (which was completed in approximately one hour) created a net cash loss of approximately $1.6 million to Compaq as follows:

			IRS Position	Compaq Position

182. Compaq Comput. Corp. v. Comm'r, 277 F.3d 778, 785 (5th Cir. 2001), *rev'g* 113 T.C. 214 (1999); *see* IES Indus. v. U.S., 253 F.3d 350 (8th Cir. 2001) (same).

183. *Compaq Comput. Corp.*, 113 T.C. at 215.

184. *Id.* at 217–18.

185. *Id.* at 218.

186. *Id.*

187. *Id.* at 219.

188. *Id.*

189. *Id.* at 221.

ADR Sale Price		$868.40		
Investment Banker Fees		<$1.5>		
ADR Purchase Price		<$887.6>		
Capital Loss			<$20.7>	<$20.7>
Dividend (Gross of $22.5 less $3.4 withholding)			$19.1 Net dividend	$22.5 Gross Dividend
	Negative Cash Flow		<$1.6>	
	Pre-Tax Net Income			$1.8
	Foreign Withholding Taxes			<$3.4>

Regarding the above facts, the Tax Court denied foreign tax credit relief because the financial arbitrage transaction lacked an adequate non-tax business purpose due to the fact that Compaq's trades were pre-wired, created a negative cash flow of $1.6 million, and were done solely to generate $3.4 million of U.S. foreign tax credits.[190] The Fifth Circuit reversed the Tax Court's decision, agreeing with Compaq that the gross dividend is used to determine whether there was a pre-tax profit motive and concluding that a pre-tax profit was the only prerequisite for the transaction to have an adequate business purpose and possess economic substance.[191] Thus, according to the Fifth Circuit, as long as Compaq possessed a pre-tax

190. *Id.* at 222, 225. The Tax Court used the economic substance doctrine to deny U.S. foreign tax credit benefits in this transaction, claiming that Compaq failed to possess a sufficient non-tax business purpose and was motivated solely by the desire to obtain U.S. foreign tax credit benefits. In the course of its opinion, the Tax Court reasoned as follows:

> The foreign tax credit serves to prevent double taxation and to facilitate international business transactions. No bona fide business is implicated here, and we are not persuaded that Congress intended to encourage or permit a transaction such as the ADR transaction, which is merely a manipulation of the foreign tax credit to achieve U.S. tax savings.

Compaq Comput. Corp, 113 T.C. at 225.

191. The Fifth Circuit reversed the Tax Court's application of the economic substance doctrine, reasoning that Compaq's economic profit is to be judged by looking at its pre-tax gross dividend and stating that foreign income taxes should not be considered as an expense, thus rejecting Notice 98-5's interpretation of the economic substance doctrine. Compaq Comput. v. Comm'r, 277 F.3d 778, 784–85 (5th Cir. 2001), *rev'g* 113 T.C. 214 (1999); *see also* IES Indus. v. U.S., 253 F.3d 350 (8th Cir. 2001).

profit ($1.8 million in the above table), it was irrelevant that this pre-tax profit suffered a pre-planned effective foreign tax rate of 189% (or $3.4 million in the above table).[192]

As cases such as *Compaq* were making their way to the courthouse, Congress enacted section 901(k) in 1997 to require a minimum holding period as a precondition to claiming U.S. foreign tax credit relief for dividend withholding taxes.[193] However, it

192. The government withdrew Notice 98-5 after its defeat in *Compaq*. *See* Notice 2004-19, 2004-1 C.B. 606 (withdrawing Notice 98-5). The Fifth Circuit's decision in *Compaq* was the subject of significant criticism by scholars. *See* Michael Schler, *Implicit Taxes and Economic Substance (letter to the editor)*, 114 TAX NOTES 959 (Mar. 5, 2007); Michael Knoll, *Implicit Taxes and Pretax Profit in* Compaq *and* IES Industries, 114 TAX NOTES 679 (Feb. 12, 2007); Burgess J.W. Raby & William L. Raby, *Other' Issues When a Tax Case Goes to Court*, 101 TAX NOTES 1097 (Dec. 1, 2003); Bryan Camp, *Form over Substance in the Fifth Circuit,* 34 TEX. TECH. L. REV. 733, 752–62 (2003); Nicholas Gunther, *Economics and* Compaq v. Commissioner, 97 TAX NOTES 555, 555 (Oct. 28, 2002); William A. Klein & Kirk J. Stark, Compaq v. Commissioner-*Where Is the Tax Arbitrage?*, 106 TAX NOTES 1335 (Mar. 7, 2002); Martin J. McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 TAX NOTES 1017, 1018 (Feb. 25, 2002); Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets it Wrong in* Compaq v. Commissioner, 26 TAX NOTES INT'L 191, 192 (Jan. 28, 2002); David P. Hariton, *The* Compaq *Case, Notice 98-5, and Tax Shelters: The Theory is All Wrong*, 94 TAX NOTES 501 (Jan. 28, 2002); Symposium, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9, 9–10 (2001); Daniel Shaviro, *Economic Substance, Corporate Tax Shelters, and the* Compaq *Case*, 88 TAX NOTES 221, 231–32 (July 9, 2000); Marc D. Teitelbaum, Compaq Computer and IES Industries—*The Empire Strikes Back*, 86 TAX NOTES 829 (Feb 7, 2000); Dana L. Trier, *Beyond the Smell Test: The Role of Substantive Anti-Avoidance Rules in Addressing the Corporate Tax Shelter Problem*, TAXES, 62, 65–70 (2000); Marc D. Teitelbaum, *An Alternative Analysis of the* Compaq *Decision (letter to the editor)*, 85 TAX NOTES 816 (Nov. 11, 1999); George K. Yin, *Making Sense of the* Compaq Computer *Case (letter to the editor)*, 85 TAX NOTES 815 (Nov. 8, 1999); Raby & Raby, *Economic Substance Needed for Foreign Tax Credit*, 85 TAX NOTES 211 (Oct. 11, 1999); Lee A. Sheppard, *Courts Combat Cross-Border Tax Shelters*, 85 TAX NOTES 137 (Oct. 11, 1999); David. P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW 235 (1999).

193. Pub. L. No. 105-34, 1053(a), 111 Stat. 788 (1997). When Congress originally enacted I.R.C. § 901(k) in 1997, it required the taxpayer to hold the stock for at least sixteen days within a thirty-day period that included the dividend record date. Congress amended I.R.C. § 901(k) to change the thirty-day period to a thirty-one-day period. Pub. L. No. 108-311, 406(g)(1), 118 Stat. 1166 (2004). *Compaq* attempted to dissuade the Tax Court from applying the judicially-created economic substance doctrine by arguing that Congress enacted I.R.C. § 901(k) as the limited response to these tax arbitrage transactions. The taxpayer made these statutory construction arguments even though the legislative history made clear that in its enactment of I.R.C. § 901(k) that "[n]o inference is intended as to the treatment under present law of tax-motivated transactions intended to transfer foreign tax credit benefits," *See* S. REP. NO. 105-33, at 177 (1997). Compaq's argument, however, was as follows:

> Congress acknowledged the economic substance of the dividend arbitrage transaction, and used a legislative scalpel to address the perceived concern, rather than the judicial hatchet wielded by the Commissioner and the Tax Court. The Tax Court's holding, if affirmed by this Court, would <u>override</u> the results mandated by

excepted certain foreign-licensed securities dealers from these holding period requirements.[194] The legislative history to section 901(k) shows that Congress' concern was that tax-motivated transactions were occurring to transfer foreign tax credits in the marketplace in short-term trades.[195] In 2004, Congress added section 901(l) to impose a similar holding period requirement for instruments that incur interest withholding taxes, but again excepted securities dealers from these new requirements.[196] Thus, even though

> Congress in section 901(k). Given that Congress has addressed the precise issue before the Court, it is particularly appropriate for the Court to decline the Commissioner's invitation to judicially modify the foreign tax credit regime in the name of economic substance. *See* Brown Group, 77 F.3d at 222. The Congressional response to the dividend arbitrage transaction in section 901(k) confirms the economic substance of Compaq's Royal Dutch dividend arbitrage transaction.

Brief of Appellant at 36, Compaq Comput. Corp. v. Comm'r, No. 00-60648 at 36 (5th Cir. 2001). The Tax Court rejected this argument. *Compaq Comput. Corp.*, 113 T.C. at 225–26 ("A transaction does not avoid economic substance scrutiny because the transaction predates a statute targeting the specific abuse"). But, the Fifth Circuit left this issue unaddressed in the course of reversing the Tax Court notwithstanding the clear statement in the legislative history that no inference should have been drawn from the enactment of I.R.C. § 901(k) as to the applicability of other doctrines to this transaction. *Compaq Comput. Corp.*, 277 F.3d at 788 ("It is unnecessary to reach the alternative arguments for reversal offered by Compaq: first, that the statutory foreign tax credit regime implicitly displaces the economic substance doctrine; and second, that a 1997 amendment to the foreign tax credit scheme, which added what is now Internal Revenue Code § 901(k), implies that ADR transactions that took place before the amendment are to be recognized for tax purposes."). This episode serves as a warning that incomplete and ad hoc policy reforms can make things worse.

194. I.R.C. § 901(k)(4) (2010). Commentators indicated that this exception represented a compromise that allowed securities dealers to continue to benefit from these foreign tax credit-generating transactions, but excluded the retail user from these techniques. *See* Lee A. Sheppard, *"What Did Wall Street Give Up for Deferral?"* 76 TAX NOTES 1665 (Sept. 29, 1997). However, section 901(k)(4) does not exclude a securities dealer unless it is held to be in active conduct in a foreign country as a securities dealer, a requirement that may prevent US-based securities dealers from being eligible for this exception. *See* Lehman Bros. Holdings, Inc. v. U.S., No. 10 Civ. 6200(RMB), 2015 WL 2359256, at *3 (S.D.N.Y. May 8, 2015).

195. *See* H.R. REP. NO. 105-148, at 545 (1997) ("[S]ome U.S. persons have engaged in tax-motivated transactions designed to transfer foreign tax credits from persons that are unable to benefit from such credits . . . to persons that can use such credits. These transactions sometimes involve a short-term transfer of ownership of dividend-paying shares. Other transactions involve the use of derivatives to allow a person that cannot benefit from the foreign tax credits with respect to a dividend to retain the economic benefit of the dividend while another person receives the foreign tax credit benefits."); S. REP. NO. 105-33, at 175-6 (1997) (same); Juliann Avakian Martin, *Foreign Tax Credit Holding Period Proposal Generates Comment*, 75 TAX NOTES 1038 (May 26, 1997).

196. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 832, 118 Stat. 1588 (2004) (adding new § 901(l)); *see also* H.R. REP. NO. No. 108-755, at 621 (Oct. 7, 2004) (Conf. Rep.) (adopting version of the house bill); H.R. REP. NO. 108-548, at 201 (June 16,

Congress failed to address the fundamental tax arbitrage aspects of the *Compaq* transaction and the new minimum holding period requirements had selective application, these provisions demonstrate an attempt to deny foreign tax credit relief for objectionable short-term financial arbitrage transactions that were executed by retail customers.

In the end, Congress's codification of the economic substance doctrine reversed the holdings of cases like *Compaq* and *IES* in that section 7701(o)(2)(B) explicitly directed the Treasury Department to issue regulations requiring foreign taxes to be treated as expenses in order to calculate the reasonably expected pre-tax profit potential of a transaction.[197]

Thus, the remedy for the foreign tax credit generator transactions set forth in Notice 98-5 was legislatively codified in the enactment of section 7701(o)(2)(B), and specific authority was given to the Treasury Department to handle these objectionable transactions in a targeted manner under the codified economic substance doctrine. By directing the Treasury Department to issue regulations that would treat a foreign tax payment as a transactional expense, section 7701(o)(2)(B) sets forth a pre-tax profit test that coherently and holistically addresses the cross-crediting concerns of

2004) ("The Committee believes that the present-law holding period requirement for claiming foreign tax credits with respect to dividends is too narrow in scope and, in general, should be extended to apply to items of income or gain other than dividends, such as interest."). The determination of what risk mitigation strategies create a tolling of the holding period creates considerable complexity in the application of this law. Nicholas Bogos, *A Risk-Based Analysis of Credit Derivation Under SSRP Standard (Part 1)*, 112 TAX NOTES 587 (Aug. 14, 2006); (Part 2), 112 TAX NOTES 655 (Aug. 21, 2006); (Part 3), 112 TAX NOTES 259 (Aug. 28, 2006).

197. 26 U.S.C.A. § 7701(o)(2)(A)(B) set forth the following criteria for analyzing whether a pre-tax profit potential is substantial enough to satisfy economic substance concerns:

> (2) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL—
>
> (A) IN GENERAL—The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.
>
> (B) TREATMENT OF FEES AND FOREIGN TAXES—Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

these abusive financial arbitrage transactions where the overall transaction creates a cash loss to the taxpayer. Ultimately section 901(k) and 901(l), along with their various scope limitations,[198] now produce needless complexity. With the enactment of section 7701(o)(2)(B), Congress should repeal sections 901(k) and (l) because the policy concerns that motivated their adoption are more appropriately solved by section 7701(o)(2)(B) without the notable favorable exceptions granted to securities dealers.

C. STARS War: The Government Strikes Back (Again)

The foreign tax credit war shifted to a more sophisticated variation in what the government came to call a structured passive investment arrangement. As indicated in the preceding section, the financial arbitrage transactions in *Compaq* and *IES* were uneconomic except for the tax credit benefits generated in those overall transactions. Thus, those are easy cases from an economic substance and business purpose perspective, despite the fact that the courts failed to arrive at the right answer and caused Congress to enact section 7701(o)(2)(B) in response.

However, the next generation of financial arbitrage transactions proved to be substantially more complex while still presenting the same fundamental cross-crediting phenomenon. Unlike *Compaq* and *IES*, the highly structured financial arbitrage transactions that utilize a structured passive investment arrangement[199] often generate an overall pre-tax profit even if the foreign tax cost is treated as an expense in the transaction. From an overall perspective, the entire transaction has a business purpose and makes overall economic sense. However, the problematic aspect of these structured passive investment arrangements centers on the fact that the transaction step that bolts-on a passive investment vehicle to an otherwise profitable transaction is extraneous to the underlying investment assets.

On one hand, the bolting-on of this passive investment vehicle to conduct the transaction, though extraneous, provides some incremental pre-tax borrowing savings to the U.S. taxpayer. However, it also results in the U.S. taxpayer incurring a substantially larger incremental foreign tax cost that far exceeds the incremental

198. *See* I.R.C. § 901(k)(4); § 901(l)(2).
199. *See* Treas. Reg. § 1.901-2(e)(5)(iv).

borrowing savings generated by the bolting-on of this otherwise extraneous passive investment vehicle.[200] Thus, if the transaction step bolted-on to the larger transaction were isolated and separately tested as an independent business decision, the additional step would have no justifiable business purpose—its addition would be solely tax motivated. Said differently, the addition of this otherwise extraneous transaction step creates incremental financial benefits that are less than the incremental foreign tax cost incurred as a result of its addition. Importantly, in these structured passive investment arrangements, the taxpayer knows upfront that the incremental savings in borrowing cost arising from the inclusion of the otherwise extraneous transaction step will be less than (and often only half of) the amount of the incremental additional foreign tax cost incurred by the inclusion of the transaction step.[201]

Prior to the enactment of section 7701(o), the Treasury Department was unsure of its prospects for victory against such structures, and so, yet again, it amended its section 901 regulations to attack this new generation of foreign tax credit generator transactions.[202] In so doing, the Treasury Department added further redundant complexity and clutter to the already complex regulatory framework of section 901. In this regard, the Treasury Department

200. The structures vary, but the essential facts are that a foreign lender invests in a foreign subsidiary. For foreign tax purposes, the foreign lender is treated as a stockholder and is entitled to be exempt on the income from its stock investment in its resident jurisdiction. The foreign lender is willing to accept a lower return than would be required if the foreign lender made a straight taxable-interest-bearing loan. Because foreign law treats the payments to the foreign lender as a dividend, the structured passive investment arrangement does not allow the foreign subsidiary to deduct its payments to the foreign lender for foreign tax purposes. The incremental additional tax cost due to the foregone interest expense deduction is about twice as much as the reduced borrowing cost. Thus, if one were to view the addition of this bolt-on structured passive investment arrangement in isolation, the pre-tax benefits are significantly less than the foreign tax cost of engaging in this structure. But, the ability to cross-credit the foreign taxes against other low tax income makes the transaction economical.

201. *See e.g.*, Salem Fin., Inc. v. United States, 112 Fed. Cl. 543, 561 (2013), *aff'd in part and rev'd in part*, 786 F.3d 932 (Fed. Cir. 2015) (Bx payment, or interest rebate, was equal to 51% of the foreign tax cost); *see also* Expert Report of Michael I. Cragg at ¶ 76; Salem Fin., Inc. v. United States, 112 Fed. Cl. 543, 561 (2013), *aff'd in part and rev'd in part*, 786 F.3d 932 (Fed. Cir. 2015).

202. *See* T.D. 9535, 76 Fed. Reg. 42,038 (July 18, 2011) (finalized in final regulations the regulatory rules for structured passive investment arrangements); T.D. 9416, 73 Fed. Reg. 40,727 (July 16, 2008) (made amendments to regulations in unrelated areas); Notice of Proposed Rulemaking, 72 Fed. Reg. 15,081 (Mar. 30, 2007) (announced special rules for structured passive investment arrangements in proposed regulations).

created a rifle-short provision in Regulation section 1.901-2(e)(5)(iv) that treats any tax payment made as part of a structured passive investment arrangement as a "voluntary" (non-compulsory) foreign tax payment. By classifying taxes generated in a structured passive investment arrangement as "voluntary," these taxes fail to meet the basic requirement of a "foreign tax" as a foreign tax must be a compulsory, rather than voluntary, payment in order to be eligible under section 901 for U.S. foreign tax credit relief.[203] In its attack on these structures, the Treasury Department provided a highly stylized set of factors that must be satisfied before an investment structure would be classified as a "structured passive investment arrangement."[204]

Because these regulations did not seek to weigh the tax and non-tax benefits of such structured passive investment arrangements, and because this regulatory prescription only applies to structures that met a formal six-part test, several comments were submitted to the Treasury Department. The comments stated that these regulations were under-inclusive because they did not address objectionable foreign tax credit benefits generated in analogous abusive structures, and yet were also over-inclusive because the regulations could disallow foreign tax credit relief even if the structured investment had a significant non-tax purpose.[205] The comments went on to state that the better means of attacking these structured passive

203. *See* Treas. Reg. § 1.901-2(e)(5)(iv); T.D. 9416, 73 FED. REG. 40,727 (July 16, 2008), corrected in 73 FED. REG. 67,387 (Nov. 14, 2008). https://1.next.westlaw.com/Document/N135C78F0167C11E3B490C480DE6B7DD7/View/FullText.html?transitionType=UniqueDocItem&contextData=(sc.Search)&userEnteredCitation=Treas.+Reg.+1.901-2.

204. *See* Treas. Reg. § 1.901-2(e)(5)(iv)(B) (setting forth six detailed criteria that must be met which in general are as follows: (i) a special purpose vehicle, (ii) a U.S. party exists who is eligible for foreign tax credit relief, (iii) direct investment is made, (iv) foreign tax credit benefit exists to a counterparty, (v) a foreign counterparty exists, and (vi) the U.S. party and foreign counterparty have inconsistent tax treatment). https://1.next.westlaw.com/Document/N135C78F0167C11E3B490C480DE6B7DD7/View/FullText.html?transitionType=UniqueDocItem&contextData=(sc.Search)&userEnteredCitation=Treas.+Reg.+1.901-2.

205. *See* Kevin Dolan, *Foreign Tax Credit Generator Regs: The Purple People Eater Returns*, 115 TAX NOTES 1155 (June 18, 2007); Comment Letter by Kevin Dolan (May 31, 2007), available at 2007 TNT 107-52, Tax Analyst Doc. 2007-13277; Comment Letter by Bret Wells (Aug. 6, 2007), available at TAX NOTES TODAY, 2007 TNT 160-10, Tax Analyst Doc. 2007-18951.

investment arrangements would have been to utilize the economic substance doctrine.[206] However, these comments were ignored.[207]

Although the STARS transactions[208] have created a spirited debate about their effectiveness under the law prior to section 7701(o)'s enactment,[209] the enactment of that section effectively ends that controversy. Section 7701(o) gives the government all the tools that it needs to deny foreign tax credit relief for foreign taxes generated in these so-called STARS transactions.[210] An analysis of the key taxpayer arguments in the STARS cases and determining how those arguments would fare under the codified economic substance doctrine set forth in section 7701(o) confirms this conclusion.

First, the taxpayers in the STARS cases argued that the economic substance doctrine should be applied to test only the business purpose for the overall transaction and not a component feature of an integrated transaction that has an overall business purpose.[211] The government has largely succeeded in convincing lower courts to apply the judicially created economic substance doctrine on a disaggregated basis in the STARS transactions such that the investment returns that would have been earned regardless of the tax structure will not cause a cash negative bolt-on structure to possess a

206. *Id*.

207. *See* T.D. 9535, 76 Fed. Reg. 42,038 (July 18, 2011).

208. One of the tax products that utilized a structured passive investment vehicle was commonly called a "STARS" transaction. To appropriately address the literature that deals with that specific context, the author refers specifically to that acronym even though the regulatory description of that transaction is a structured passive investment arrangement.

209. *See* Kevin Dolan, *The Foreign Tax Credit Diaries—Litigation Run Amok*, 140 TAX NOTES 1465 (2013); Jasper Cummings, Jr., *The Economic Substance Doctrine as Penalty*, 138 TAX NOTES 1465 (2013); Richard Lipton, BNY *and* AIG*—Using Economic Substance to Attack Transactions the Courts Do Not Like*, 119 J. TAX'N 40 (July 2013); Lee Sheppard, *Can the FTC Generator Decisions Be Reconciled?* 141 TAX NOTES 451 (Nov. 4, 2013); Lee Sheppard, *Foreign Tax Credit Generator Disallowed*, 133 TAX NOTES 400 (Oct. 24, 2011); Lee Sheppard, *Banks' Foreign Tax Credit Arbitrage*, *Part 3*, 116 TAX NOTES 824 (Sept. 3, 2007); Lee Sheppard, *Banks' Foreign Tax Credit Arbitrage, Part 2*, 115 TAX NOTES 99 (Apr. 9, 2007); Lee Sheppard, *Banks' Foreign Tax Credit Arbitrage*, 2006 TNT 137-4 (July 18, 2006).

210. Evidently, the acronym STARS was the acronym used by the promoter of these passive investment trust structures and stands for Structured Trust Advantaged Repackaged Securities transaction. *See* Bank of New York Mellon v. Comm'r, 140 T.C. 15, 16–17 (2013) (where Tax Court indicates the acronym and its origin).

211. *See*, *e.g.*, Appellant Brief at 22, 42–56, Bank of New York Mellon v. Comm'r, 2014 WL 2799053 (June 12, 2014); Appellant Brief at 38–40, American Int'l Group v. United States, 2014 WL 3402503 (June 30, 2014).

sufficient business purpose for its inclusion.[212] Whether or not this success continues, section 7701(o)(5)(D) explicitly rejects the taxpayers' argument by stating that the economic substance doctrine can be applied to an individual transaction step to determine the independent business purpose and economic substance of the particular transaction step that generates U.S. tax benefits.[213] Thus, in years where section 7701(o)(5)(D) is effective, taxpayers will not be able to argue that a bolt-on extraneous tax strategy can benefit from being part of a larger transaction that has an overall business purpose.

The second key taxpayer argument in the STARS cases is that foreign taxes should not be considered an expense in determining whether the transaction possesses a pre-tax profit motive a la *Compaq* and *IES*.[214] Section 7701(o)(2)(B) explicitly repudiates this position

212. *See* Salem Fin., Inc. v. United States, 112 Fed. Cl. 543 (2013). The U.S. Court of Federal Claims disallowed deductions and credits generated in BB&T's participation in a STARS transaction by testing the trust structure as a separate step. *Id*. The court stated as follows:

> The trust creates a series of instantaneous circular cash flows starting and ending with BB & T where no economic activity has occurred abroad to justify the assessment of a U.K. tax. While inarguably sophisticated and creative, the trust purely and simply is a sham transaction accomplishing nothing more than a redirection of cash flows that should have gone to the U.S. Treasury, but instead are shared among BB & T, Barclays, and the U.K. Treasury. The Court finds that the trust component of STARS lacks economic substance.

Aff'd in part and rev'd in part and remanded, Salem Fin., Inc. v. United States, No. 2014-5027, 786 F.3d 932 (Fed. Cir. 2015), *cert. denied*, Sup. Ct. Dk. No. 15-380 (2016); Bank of New York Mellon v. Comm'r, 140 T.C. 15 (2013), *supplemented by* T.C. Memo. 2013-225 (2013) (found that the STARS transaction lacked economic substance by separately testing the business purpose and economic substance of the passive investment trust in the structure, stating that "the relevant transaction to be tested is the one that produces the disputed tax benefit, even if it is part of a larger set of transactions or steps" and that "the requirements of the economic substance doctrine are not avoided simply by coupling a routine transaction with a transaction lacking economic substance."); Am. Int'l Grp. v. United States, 111 A.F.T.R. 2d 2013-1472 (D.C.N.Y. 2013) (holding that use of the structured investment vehicle had no economic substance or business purpose). *But see* Santander Holdings USA, Inc. v. U.S., 977 F. Supp. 2d 46 (D. Mass. 2013) (refusing to disaggregate the STARS transaction to test the economic substance of the transaction step and instead found economic substance given the profitability of the overall transaction).

213. *See* I.R.C. § 7701(o)(5)(D); STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE RECONCILIATION ACT OF 2010, as amended, in combination with the PATIENT PROTECTION AND AFFORDABLE CARE ACT, at 153 (2010).

214. *See*, *e.g.*, Appellant Brief at 37–42, Bank of New York Mellon v. Comm'r, 2014 WL 2799053 (June 12, 2014); Appellant Brief at 40–49, American Int'l Grp. v. United States, 2014 WL 3402503 (June 30, 2014).

by directing the Treasury Department to issue regulations to treat foreign taxes as an expense as part of the assessment of the nontax profit motive of the taxpayer.

The combination of section 7701(o)'s two clarifications, therefore, requires courts to analyze the transaction step that generates excess foreign tax credits in isolation and to view any foreign taxes as an expense to determine the profit motive of this isolated step. Courts applying this methodology to STARS transactions, should find that the incremental foreign tax cost incurred as a result of the inclusion of the structured passive investment vehicle far exceeds the incremental expected savings in borrowing costs derived by including this structured passive investment vehicle into the overall investment strategy. Regardless of how these STARS cases are ultimately resolved under the judicially created economic substance doctrine,[215] the litigating position of the taxpayer in those cases makes it clear that section 7701(o) should disallow the tax credits generated in the STARS-type transaction in years where the codified version of the economic substance doctrine applies.[216]

215. Taxpayers in several of these cases have petitioned the U.S. Supreme Court to hear these cases. *See*, *e.g.*, American Int'l Grp. v. United States, petition for cert. filed, (Oct. 13, 2015) (No. 15-478); Mellon Bank of New York v. Comm.'r., petition for cert. filed, (Nov. 2, 2015) (No. 15-572); Salem Financial v. United States, petition for cert. filed, (Sept. 29, 2015) (No. 15-380), cert. denied, (Mar. 7, 2016). However, the U.S. Supreme Court refused certiorari in these cases, thus letting the lower court victories in these cases stand.

216. In the legislative history to I.R.C. § 7701(o), it was stated that routine business transactions such as "(1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of I.R.C. § 482 and other applicable concepts are satisfied." *See* STAFF OF THE JOINT COMM. ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE PATIENT PROTECTION AND AFFORDABLE CARE ACT at 379 (2011). As has been pointed out by Professor Luke, this legislative history provides two caveats to reliance on this safe harbor list: "(1) whether a particular transaction meets the requirements for specific treatment under any of these provisions can be a question of facts and circumstances and (2) the fact that a transaction does meet the requirements for specific treatment is not determinative of whether a transaction or series of transactions of which it is a part has economic substance. A taxpayer may not escape the economic substance doctrine through labeling an activity as a 'basic business transaction'; the facts and circumstances must clearly show that the transaction is in line with existing authorities." *See* Charlene Luke, *The Relevance Game: Congress's Choices for Economic Substance Gamemakers*, 66 TAX LAW 551, 572 (2013).

However, section 7701(o) may do more than simply solve the problem prospectively, as its existence seems to be impacting the development of the judicially created economic substance doctrine. The Tax Court in *Bank of New York Mellon v. Commissioner* looked to the legislative history accompanying section 7701(o) to support its application of the judicially created economic substance doctrine, thus harmonizing its pre-section 7701(o) decision with the manner in which the economic substance doctrine was codified in section 7701(o).[217] Other cases have refused to rule in favor of taxpayers as a matter of law and are proceeding to trial[218] or are the subject of interlocutory appeals.[219]

These cases in the pre-section 7701(o) era appear to be trending in favor of the government, and in any event the strongest arguments in the taxpayer's favor are arguments that cannot be made in years that are subject to section 7701(o)'s restrictions. The government has also been successful in disallowing foreign tax credits when the U.S. taxpayer is a lender (not a preferred equity investor) with respect to a structured passive investment arrangement, demonstrating the effectiveness of the economic substance doctrine at handling variations in these highly structured transactions.[220] Given that the generation of objectionable excess

217. *See* Bank of New York Mellon v. Comm'r, 140 T.C. 15, 34–35 n.8, n.9 (2013) *supplemented by* T.C. Memo. 2013-225 (2013) (Tax Court cites legislative history to I.R.C. § 7701(o) as confirmation of the relevant cases that should be used in applying the judicially-created economic substance doctrine).

218. *See* Wells Fargo & Co. v. United States, 2013 WL 6017366 (D. Minn. 2013).

219. *See* American Int'l Grp., Inc. v. United States, 111 A.F.T.R.2D 2013-1472 (S.D.N.Y. 2013) (court stated that the economic substance doctrine's purpose is "to determine whether AIG merely sought to minimize its tax burden on otherwise profitable spread banking activity, or whether the spread between AIG's cost of borrowing and its return on investment existed only because of the transactions' tax consequences including its negotiated division of its inherent tax benefits"). The district court did allow the case to proceed on an interlocutory appeal. *See* American Int'l Group, Inc. v. United States, 112 A.F.T.R.2d 2013-7206 (S.D.N.Y. 2013).

220. In *Pritired*, the taxpayer was disallowed more than $20 million in foreign tax credits generated in a highly structured transaction involving a $300 million payment to two French banks. The court ruled against the taxpayer on multiple grounds, finding that the transaction was a loan rather than an equity investment (thus no I.R.C. §902 credits were available), that the transaction lacked economic substance, that the transaction violated the partnership anti-abuse rules of Treas. Reg. § 1.701-2, and that the transaction had no business purpose and no reasonable expectation of profit. *See* Pritired 1 LLC v. United States, No. 4:08-cv-00082, 816 F.SUPP. 2D 693 (S.D. Iowa 2011). For a criticism of the *Pritired* decision, see Jasper Cummings, *Preferred Stock and the Special Purpose Issuer*, 135 TAX NOTES 1665 (July 12, 2012).

foreign tax credits posited by the STARS transactions is adequately addressed by section 7701(o) in a principled manner, the redundant application of Regulation section 1.901-2(e)(5) represents needless complexity that should be removed.

D. U.S. Tax Versus Foreign Tax Permanent Basis Differences and Section 901(m)

An early means of generating excessive amounts of foreign tax credits arose in instances where foreign law defined taxable income in a way that was different from (and broader than) the U.S. definition of taxable income, thus creating a permanent tax basis difference between the two jurisdictions. In this situation, foreign taxes for the full amount were claimed by the U.S. taxpayer even though a significant portion of the foreign taxes related to items of income that were excluded from any U.S. taxation. In G.C.M. 26062, 1949-2 C.B. 110, the IRS argued that foreign taxes assessed on amounts excluded from U.S. taxation should not be eligible for U.S. foreign tax credit relief because allowing those credits inflated the amount of foreign tax credits beyond what was required to avoid international double income taxation and generated inappropriate cross-crediting. The government felt that international double income taxation was already avoided if the United States did not assert taxing jurisdiction over the item that foreign law sought to tax. Under this view, providing a cross-crediting opportunity for taxes assessed on excluded income was arguably overly generous.

This argument represented an early effort to prevent inflated amounts of U.S. foreign tax credit relief. However, this effort to deny foreign tax credit relief for taxes paid on items that would never be part of the U.S. tax base was largely rejected by the courts.[221] Consequently, after largely failing to convince courts to engage in a facts and circumstances inquiry to determine whether foreign tax credit relief was appropriate as a precondition to the grant of such

221. *See* Helvering v. Nell, 139 F.2d 865, 870–71 (4th Cir. 1944); I.B. Dexter v. Comm'r, 47 B.T.A. 285, 290–91 (1942), *acq.,* 1948-2 C.B. 1; Brace v. Comm'r, 11 T.C.M. (CCH) 906, 907, T.C.M. (P-H) ¶ 52, 265, at 800–01 (1952); United States v. Rexach, 200 F. Supp. 494, 496 (D.P.R. 1961) (considering the argument raised by the Service that the foreign tax credit is allowed only for items subject to U.S. tax an "extinct question"). *But see* Hubbard v. United States, 17 F. Supp. 93 (Ct. Cl. 1936) (ruling in favor of the IRS that foreign tax credits should not be allowed to the extent assessed on amounts that were not taxable in the United States).

relief under section 901, the IRS in 1954 abandoned its arguments that foreign tax credit relief should only be available when true international double income taxation was possible with respect to the underlying item that was assessed a foreign tax.[222] Here things remained until 2010.

Congress eventually reacted to the cross-crediting opportunities afforded by tax basis differences with the enactment of section 901(m).[223] In general, section 901(m)(1) denies U.S. foreign tax credit relief for any foreign taxes attributable to the disqualified portion of foreign income arising in a covered asset acquisition. Section 901(m)(2) provides that a covered asset acquisition includes any transaction that is treated as an asset acquisition for U.S. tax purposes but is treated as a stock purchase for foreign income tax purposes. Thus, section 901(m) can apply in instances where (i) stock in a foreign entity is sold and a section 338 election is made, (ii) stock in a foreign entity is sold and the foreign entity is considered a disregarded entity for U.S. tax purposes, or (iii) an interest in a foreign entity is sold and the foreign entity is treated as a partnership for U.S. tax purposes.[224] Section 901(m)(3)(a) provides that the disqualified portion of foreign taxes is the incremental foreign income tax paid as a result of a permanent tax basis difference.[225] The purpose of section 901(m) is to deny foreign tax credit relief for foreign taxes imposed on foreign income that is not taxable in the United States. This occurs under the theory that international double income taxation is already avoided due to the

222. The Service formally abandoned this position in Rev. Rul. 54-15, 1954-1 C.B. 129; *see also* Treas. Reg. § 1.904-6(a)(1)(iv) (places foreign tax credit for items not subject to U.S. tax in the general basket, thus accepting their creditability and placing them in the basket that provides the most protection against the cross-crediting phenomenon).

223. *See* PUB. L. 111-226, §212 (Aug. 11, 2010).

224. *See* Joint Comm. on Taxation, "Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010, JCX-46-10 (Aug. 10, 2010) at 10.

225. I.R.C. § 901(m)(3)(A) achieves this by stating that the disqualified portion means the ratio of the aggregate percentage basis differences allocable to such taxable year divided by the income which the foreign tax is applied. I.R.C. § 901(m)(3)(C)(i) provides that the basis difference means the excess of the adjusted basis of such asset immediately after a covered asset acquisition over the adjusted basis of such asset immediately before the covered asset acquisition. I.R.C. § 901(m)(3)(B)(i) provides the general rule that the basis difference will be allocated to taxable years using the applicable recovery method for U.S income tax purposes.

nontaxability of the particular item that was subjected to foreign taxation. The illustration below sets forth the analysis:

> **Illustration #1.** USP purchases the stock of a foreign target (FT) for $100. FT made substantial use of its assets in its trade or business. The inside basis in the assets is $40. USP makes a section 338(g) election, thus stepping up the basis of the assets for U.S. tax purposes. However, no basis step-up exists for local tax purposes as the transaction is treated as a stock purchase for local tax purposes. Assume that the additional $60 of basis step-up is amortized over a 15-year period ($4 of additional amortization annually). Assume that FT has $24 of income (before the additional amortization) and pays a foreign tax at a 25% tax rate, so on these facts FT pays a total of $6 of local income tax. Consequently, in this situation, $4 of the $24 of FT's income will never be subject to U.S. taxation due to the $4 of additional amortization deductions, and so the corresponding $1 of foreign tax assessed on this excluded $4 of income need not be given foreign tax credit relief because double taxation is already avoided on the $4 of foreign income to which this $1 of tax relates. Thus, section 901(m) disallows the $1 of foreign tax that is attributable to the income that is sheltered by reason of the amortization of the tax basis difference that was created by reason of the covered asset acquisition.[226]

The justification for section 901(m) harkens back to the policy arguments first expressed in G.C.M. 26062. For U.S. tax purposes, the assets in Illustration #1 experience a basis step-up in a transaction where no foreign taxable event occurred. The amortization of this additional stepped-up basis creates a permanent reduction in the portion of foreign income that will be taxed in the United States versus what will be subject to tax in the foreign jurisdiction where no basis step-up was provided. Thus, in this situation, for U.S. tax purposes the buyer can obtain a basis step-up in the underlying FT assets in a transaction where the seller was not subject to a taxable event in a foreign jurisdiction, creating a permanent basis difference between the United States and the relevant foreign jurisdiction. The foreign taxes associated with the excluded income (by reason of the additional U.S. amortization deduction) are disallowed under section 901(m) because international double income taxation is

226. For a further analysis of the interplay between I.R.C. § 901(m) and I.R.C. § 338(g), see Lowell Yoder, *Section 338(g) Election for a Foreign Tax Continues to Provide Benefits to Buyer After New Section 901(m)*, 40 TAX MGMT. INT'L J. 347 (June 10, 2011).

already avoided with respect to the particular item of income to which those taxes relate. In the context of this "one-sided taxable transaction," it seems appropriate to prevent the buyer from benefitting from both an asset step-up (that created no tax consequence to the seller) and also from allowing all U.S. foreign tax credits. Section 901(m), therefore, arguably prevents a U.S. tax benefit that is beyond what is necessary to simply prevent double international income taxation.

However, even though the core theory behind section 901(m) can be rationalized to achieve an appropriate outcome, the actual breadth of section 901(m) creates instances where it inappropriately disallows U.S. foreign tax credit relief. This is particularly true when the seller in the transaction is a U.S. corporation or a controlled foreign corporation of a U.S. corporation and a section 338(g) election has been made. Illustration #2 sets forth the relevant issues:

> **Illustration #2.** The facts are the same as Illustration #1 except now it is assumed that the seller of FT is a U.S. corporation or a controlled foreign corporation that is wholly owned by a U.S. corporation (hereafter, "U.S. Seller"). USP makes a section 338(g) election. USP and the U.S. Seller report the transaction consistently as a deemed asset sale for U.S. tax purposes.

In Illustration #2, the U.S. Seller's tax consequences with respect to the deemed asset sale will be consistently reported to the United States government. The United States asserts the right to subject the U.S. Seller's income on this deemed asset sale to U.S. net income taxation[227] with the cross-crediting opportunity limited due to section 338(h)(16).[228] Given that the United States is a relevant

227. Since § 338(h)(16) treats the gain on the deemed asset sale as a gain arising from a stock transaction, the gain is passive foreign personal holding company income if earned in the hands of a controlled foreign corporation, so it will be subject to immediate U.S. taxation even if the U.S. Seller is a controlled foreign corporation. *See* § 954(c).

228. Under § 338(h)(16), the seller's additional § 1248 amount resulting from the seller's deemed asset sale arising from a regular § 338(g) election cannot be treated as general basket foreign-source income but is instead sourced based on the sourcing rules for capital gain on the sale of the stock which results in this gain either being US-sourced (the result generally afforded if the U.S. Seller were a U.S. corporation) or passive basket foreign-source income (the result if the U.S. Seller were a controlled foreign corporation). *See* § 865(a) and (f). Either way, cross crediting is prevented either by § 904(a) when the U.S. Seller is a U.S. corporation or by treating the income as passive basket income per § 904(d)(2) when the U.S. Seller is a controlled foreign corporation. *See* Reg. § 1.338-4(h)(8) Ex. 4; *see also* Kevin Dolan, Philip Tretiak, & Ronald Dabrowski, *U.S. Taxation of International Mergers, Acquisitions, and*

jurisdiction of both the USP and U.S. Seller in Illustration #2, and because the U.S. tax laws restrict the cross-crediting options with respect to the U.S. Seller's taxable gain (via section 338(h)(16)), it is inappropriate to deny U.S. foreign tax credits to USP by reason of section 901(m). Viewed from an overall perspective, the basis step-up afforded to USP represents only a timing difference, not a permanent basis difference, since USP's basis step-up was created in a transaction where the U.S. Seller's gain was subject to U.S. net income taxation. Thus, the extra amortization deductions afforded to USP represent only the other side of a transaction where the U.S. Seller was subject to U.S. net income taxation with respect to its deemed asset sale.

Section 901(m)(7) grants broad authority to the Treasury Department to modify the application of section 901(m) to avoid inappropriate foreign tax credit disallowance results. It states that the Treasury Department "may issue regulations or other guidance as is necessary or appropriate to carry out the purposes of [section 901(m)], including to provide . . . an exemption for certain covered asset acquisitions."[229] The legislative history indicates the following context:

> In cases in which there has been a covered asset acquisition that involves either (1) both U.S. assets and relevant foreign assets, or (2) assets in multiple relevant jurisdictions, it is anticipated that the Secretary may issue regulations clarifying the manner in which any relevant foreign asset (such as intangible assets that may relate to more than one jurisdiction) are to be allocated between those jurisdictions.

Congress recognized that its promulgation of section 901(m) might be overbroad and potentially provide inappropriate results, so

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Joint Ventures at ¶2.03[2][b] (WG&L updated Nov. 2014). For an analysis of how section 338(h)(16) can create results that are harsher when the total earnings and profits in the controlled foreign corporation exceed the seller's gain with the consequence that the seller would be entitled to less deemed paid credits than would otherwise be available if no section 338 election were made, see Lowell D. Yoder, *CFC Target: To Make or Not to Make a Code Sec. 338 Election,* 3 J. TAX'N OF GLOBAL TRANS. 3 (Winter 2004); Lowell D. Yoder, *CCA 200103031: Does §338(h)(16) Apply to Deemed-Paid Credits?*, 30 TAX MGMT. INT'L J. 443 (Oct. 12, 2001).

229. *See* Joint Comm. on Taxation, Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010, JCX-46-10 at 16 (Aug. 10, 2010).

it was careful to delegate regulatory authority to the Treasury Department to address any inappropriate application of section 901(m). The Treasury Department should use its delegated authority under section 901(m)(7) to promulgate regulations to exempt from section 901(m)'s disallowance rules any stock transaction between USP and the U.S. Seller that is treated as a deemed asset acquisition by reason of section 338 where the seller is a U.S. Seller. In this context, the "relevant foreign jurisdiction" is in fact the United States because the United States has jurisdiction to assert taxation over both USP and the U.S. Seller, thus ensuring that the basis step-up arises in a transaction that affords consistent treatment toward both the buyer and the seller side of the transaction in the relevant jurisdiction of each.

The United States has ensured (via section 338(h)(16)) that this regular section 338(g) election has not afforded an inappropriate cross-crediting opportunity for the U.S. Seller. Also, the U.S. Seller's gain is subject to immediate U.S. taxation. For these two reasons, the facts set forth in Illustration #2 indicate that the U.S. tax system does not suffer a distortion from an overall perspective because there is no "one-sided taxable event." Said differently, because the United States is a "relevant jurisdiction" on both the buyer and the seller side of the transaction and has taken steps to limit the cross-crediting opportunities afforded to the U.S. Seller, there is no inappropriate foreign tax credit benefit generated from a US tax policy perspective in this situation. Consequently, in this context, any "double benefit" afforded to USP in this Illustration #2 is offset by the fact that the U.S. Seller must consistently treat this taxable event as a deemed asset sale for U.S. tax purposes, and is ultimately subject to U.S. taxing jurisdiction on this transaction. Given this symmetrical treatment, it seems inappropriate to disallow foreign tax credit relief in this fact pattern as USP's basis step-up is simply a timing difference, not a permanent difference, from the overall U.S. tax regime's perspective.

A harder conceptual case exists if the facts are slightly revised as follows:

> **Illustration #3.** The facts are the same as Illustration #2 except that no section 338 election is made and FT is treated as a disregarded entity for U.S. tax purposes. The U.S. Seller sells all the stock of the disregarded entity to USP.

In this fact pattern, USP again is treated as having purchased the underlying assets of FT for U.S. tax purposes, and thus USP is afforded a stepped-up basis in the underlying FT assets. The U.S. Seller is subject to this same consistent deemed asset sale characterization for U.S. tax purposes. Thus, as in Illustration #2, the United States is a "relevant jurisdiction" that is asserting at least residual taxing jurisdiction on both the buyer and the seller in this transaction. However, unlike Illustration #2, now the U.S. Seller's taxable gain is not subject to the restrictions of section 338(h)(16).[230] In the context of the facts set forth in Illustration #3, the U.S. Seller's gain is likely to be considered low-tax foreign-source general basket income.[231] Thus, U.S. taxation over this deemed asset gain is preserved only on a residual basis and affords the U.S. Seller with a potential cross-crediting opportunity (via the generation of low-tax general basket income that can utilize excess credits from other transactions).[232]

In addition, just as in Illustration #2, USP is likely to generate excess foreign tax credits as a result of the amortization of the permanent basis difference. So, Illustration #3 raises the question of whether section 901(m) is principally bothered about the "one-sided nature" of a deemed asset acquisition (asset basis step-up to the buyer without consistent taxable asset sale characterization in the seller's relevant taxing jurisdiction) or whether section 901(m) is concerned about cross-crediting opportunities for USP (via excess credits generated) in transactions where the U.S. Seller is afforded generous cross-crediting opportunities with respect to its deemed asset gain. Comments have been submitted to the Treasury

230. The Treasury Department has recommended that the principles of section 338(h)(16) should be extended to apply to all covered asset acquisitions described in section 901(m). *See* TREASURY DEPARTMENT, GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROVISIONS at 30–31 (Feb. 2016).

231. Because the asset gain relates to assets sold that are used in the active conduct of a trade or business, the gain is not characterized as foreign personal holding company income under section 954(c). *See* Treas. Reg. § 1.954-2(e)(1)(ii). Furthermore, because assets in Illustration #1 are assets used in a trade or business (and thus do not give rise to rents and royalties), the sale of these assets will be exempted from the foreign base company sales rules regardless of how these assets were originally acquired. *See* Treas. Reg. § 1.943-3(a). Thus, the gain, if recognized in a controlled foreign corporation, is not likely to be subject to subpart F taxation. Finally, because the gain from this transaction is not described in section 954(c), the gain will all be placed in LuxCo's general basket. *See* § 904(d)(2)(A)(i) and (B)(i). For a further analysis of this planning strategy, see Kevin Dolan, Philip Tretiak, & Ronald Dabrowski, *U.S. Taxation of International Mergers, Acquisitions, and Joint Ventures* at ¶2.01[4] (WG&L updated Nov. 2014).

232. *See* § 904(d)(1).

Department that posit this situation and indicate that competing policy claims can be made on whether section 901(m) should apply in this context.[233] The legislative history is unclear on what the fundamental policy objective is, and so the Treasury Department should articulate clearly what the fundamental result is in this Illustration #3.

III. Reconstructing Section 901 for the Post-War Era

Section 901's complexity was a result of a legitimate concern. The foreign tax credit war was a real war. The threats posed by transactions that artificially generate excess foreign tax credits represent real policy problems. Since at least 1975, Congress and the Treasury Department have been convinced that the cross-crediting phenomenon arising from "objectionable transactions" requires a response in addition to simple reliance on section 904. Thus, it is understandable that Congress and the Treasury Department would seek to redefine the foreign tax credit eligibility standards in response to transactions where foreign tax credits are generated in objectionable ways. The dual capacity taxpayer regulations of Regulation section 1.901-2A, the codified economic substance doctrine contained in section 7701(o), and section 901(m)'s disallowance of taxes attributable to permanent tax basis differences together represent a principled approach to the inappropriate generation of excess foreign tax credits. These provisions were needed, and they solved real problems.

However, this is the extent to which positive things can be said. The historical record indicates that Congress and the Treasury Department ran roughshod over section 901 and used a scorched earth approach in their war against objectionable foreign tax credit transactions. The resulting carnage has caused the U.S. foreign tax credit regime to become a "byzantine structure of staggering complexity."[234] The rush to enact reforms resulted in ill-conceived regulations. The separate limitation regime of section 907, the formalistic aspects of the predominant character standard in Regulation section 1.901-2(b), the selectively applied minimum holding period requirements of sections 901(k) and (l), and the

233. *See* New York Bar Association, *Report on Section 901(m)* at 15–16 (Jan. 28, 2011).

234. *See supra* note 24.

noncompulsory payment criteria for structured passive investment arrangements in Regulation section 1.901-2(e)(5) represent a plethora of redundant and obsolete complexity. Even worse, because these redundant, ad hoc provisions were not targeted in scope, they create incoherent instances of international double income taxation, even when the underlying transactions are not objectionable.

The occurrence of international double income taxation is an incoherent outcome when the taxpayer has substantively paid foreign income taxes in a non-objectionable transaction and yet is denied U.S. foreign tax credit relief. The United States government continues to assert worldwide residency-based taxation (either on a current or deferred basis), and thus must have a coherent foreign tax credit regime to complement that tax policy orientation given that our major trading partners have chosen to enact territorial tax regimes that outright structurally avoid international double income taxation outcomes. For that reason, the overbroad and redundant foreign tax credit disallowance provisions should be removed, especially considering that Congress and the Treasury Department have enacted more targeted responses that work without the need for these additional provisions.

With more and more countries adopting territorial tax regimes, the United States simply must have a principled and coherent foreign tax credit regime that balances the need to prevent international double income taxation with the need to prevent the generation of artificially excessive amounts of foreign tax credits through objectionable transactions. Objectionable foreign tax credit transactions that generate excessive and artificial amounts of U.S. foreign tax credit relief needed principled responses, and principled responses were enacted in the midst of a scattergun attack on these objectionable transactions. But, now that these historic issues are adequately addressed, it is time, in this post-war era, to remove the ad hoc and redundant bulwarks that were added to section 901 in the foreign tax credit war. Those provisions create a significant risk of incoherent outcomes and unjust instances of international double income taxation. As countries evolve and adapt their tax laws to protect against the BEPS phenomenon, their adoption of formulary measures and disallowance rules create the risk of needless and inappropriate amounts of double international income taxation under the existing 1983 final regulations. The U.S. foreign tax credit regime must be overhauled, and now is the time to clean up this important area of the law so that U.S. multinational enterprises do not suffer international double income taxation on income that has already been subject to foreign income taxes in non-objectionable situations.