US
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Foreign tax credits

Earlier this year the IRS issued a technical advice memorandum (TAM 200807015) disallowing foreign tax credits claimed by a US bank in a structured foreign tax credit transaction. A TAM is guidance provided by the Office of Chief Counsel upon request of an IRS director. It represents a final determination of the position of the IRS with respect to the specific issue on which the TAM is issued. Generally, a request for a TAM stems from an examination of a taxpayer's return or a consideration of a taxpayer's claim for a refund or credit. This TAM marks the first concrete evidence that the IRS is coming good on its promise to attack structured foreign tax credit transactions when it finds them.

In the transaction, a US corporation invested in a hybrid instrument issued by a UK entity designed to be treated as debt for UK tax purposes but as a partnership interest for US tax purposes. The issuer purchased a perpetual note issued by the issuer's ultimate parent, a UK bank. The issuer paid UK tax on income from the perpetual note. The US corporation asserted it was a partner in the issuer for US tax purposes and claimed a foreign tax credit for the UK tax paid by the issuer.

The TAM set out four reasons the foreign tax credit should be disallowed. Payment of the UK tax was a non-compulsory payment because the UK group failed to elect group relief under UK law in a manner that would have eliminated the UK tax. The hybrid instrument was debt rather than a partnership interest for US tax purposes. The IRS argued that, through an auction process, the holder was entitled to seek redemption of its security after one year and that this made the hybrid debt or debt-like for US federal income tax purposes. The partnership anti-abuse rule applied to the transaction because the partners' tax liability was less than if they had invested in the perpetual note directly; and the transaction lacked economic substance.

The TAM asserts that the US corporation must include the net income from the investment, but should not be allowed a credit for the UK tax paid. Accordingly, under the TAM the US corporation would in effect be subject to both UK and US tax on income from the perpetual note.

In March 2007, the IRS issued proposed regulations that disallow credits with respect to payments of foreign taxes attributable to certain structured passive investment arrangements. The principal elements of such an arrangement are (i) a special-purpose vehicle (SPV) earning substantially all passive income and paying a foreign tax; (ii) a US person eligible to claim a credit for that foreign tax; (iii) the foreign tax is substantially greater than it would have been had the US person directly owned the SPV's assets; (iv) a foreign tax benefit to an unrelated counterparty; (v) an unrelated counterparty that owns at least 10% of the SPV or acquires at least 20% of the value of the assets of the SPV; and (vi) different treatment by the US and the applicable foreign country of certain aspects of the arrangement under their respective tax systems.

It seems likely that under the proposed regulations the US corporation would have been precluded from claiming a credit for the UK taxes paid by the issuer. The proposed regulations, however, would only be applicable to foreign taxes paid or accrued during taxable years ending on or after the date on which they are finalised.

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