

# **Foreign Tax Credit Abuse**

## **Notice 2004-19**

### PURPOSE

The purpose of this notice is to describe the approach that the Treasury Department and the Internal Revenue Service (IRS) are using to address transactions involving inappropriate foreign tax credit results and to withdraw Notice 98-5, 1998-1 C.B. 334, because Treasury and the IRS do not intend to issue regulations in the form described in that notice.

## BACKGROUND

Notice 98-5 announced that Treasury and IRS intended to issue regulations that would apply an economic profit test to address abusive tax-motivated transactions that generate foreign tax credits that can be used to reduce residual U.S. tax on other foreign source income. Part II of Notice 98-5 describes two classes of transactions that create the potential for foreign tax credit abuse. The first class includes transactions that effectively transfer a foreign tax liability through the acquisition of an asset that generates an income stream subject to foreign gross basis taxes such as withholding taxes. The second class includes cross-border tax arbitrage transactions that effectively permit the duplication of tax benefits. Notice 98-5 contemplated that regulations would apply an economic profit test to disallow credits for foreign taxes generated in an arrangement such as those described above if the reasonably expected economic profit were determined to be insubstantial compared to the value of the foreign tax credits expected to be obtained as a result of the arrangement. Notice 2003-76, 2003-49 I.R.B. 1181, and its predecessors identified transactions that are the same as or substantially similar to transactions described in Part II of Notice 98-5 as listed transactions for purposes of the tax shelter disclosure, registration, and list maintenance requirements of § 1.6011-4 of the Income Tax Regulations and §§ 301.6111-2 and 301.6112-1 of the Procedure and Administration Regulations.

## DISCUSSION

Treasury and the IRS do not intend to issue regulations in the form described in Notice 98-5. Accordingly, Notice 98-5 is withdrawn. Consistent with this withdrawal, Notice 2003-76 is modified by eliminating the reference to Notice 98-5 in the identification of listed transactions. Accordingly, transactions will not be considered listed transactions for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2) solely because they are the same as or substantially similar to the transactions or arrangements described in Part II of Notice 98-5. No inference is intended, however, as to whether such transactions are otherwise subject to the disclo-

sure requirements of section 6011, the registration requirements of section 6111, or the list maintenance requirements of section 6112.

Treasury and the IRS remain concerned about transactions that involve inappropriate foreign tax credit results. The tax benefits claimed in these transactions are inconsistent with the purposes of the foreign tax credit provisions, including the foreign tax credit limitation of section 904, which are intended to reduce or eliminate double taxation of income.

The IRS will continue to scrutinize abusive transactions that are designed to generate foreign tax credits. In appropriate circumstances, the IRS will challenge the claimed tax consequences of such transactions under the following principles of existing law: the substance over form doctrine, the step transaction doctrine, debt-equity principles, section 269, the partnership anti-abuse rules of § 1.701-2, and the substantial economic effect rules of § 1.704-1.

Treasury also has proposed legislative changes to address transactions involving inappropriate foreign tax credit results. Section 901(k), which was enacted in 1997, disallows a credit for certain foreign taxes paid with respect to a dividend if the recipient of the dividend does not meet certain holding period requirements or is under an obligation to make related payments with respect to substantially similar or related property. The Administration's FY 2005 Budget includes a proposal to expand section 901(k) to apply to foreign taxes with respect to income or gain other than dividends (such as interest, rents, and royalties), disallowing a credit for foreign withholding taxes if the recipient of the income or gain does not meet certain holding period requirements with respect to the asset generating the income or is under an obligation to make related payments with respect to substantially similar or related property. See Department of the Treasury, General Explanation of the Administration's Fiscal Year 2005 Revenue Proposals at 113 (Feb. 2004). This proposed expansion of section 901(k) addresses the first class of transactions described in Notice 98-5. This proposal was also included in the Administration's FY 2004 Budget and has been incorporated in pending proposed legislation. See Department of the Treasury, General Explanation of the Ad-

ministration's Fiscal Year 2004 Revenue Proposals, at 103 (Feb. 2003); American Jobs Creation Act, H.R. 2896, 108<sup>th</sup> Cong. § 3022 (2003); Jumpstart Our Business Strength Act, S. 1637, 108<sup>th</sup> Cong. § 456 (2003).

The Administration's FY 2005 Budget also includes a proposal for broad regulatory authority to address transactions that involve inappropriate separation of foreign taxes from the related foreign income in cases where foreign taxes are imposed on any person with respect to income of an entity. The regulations that would be issued under this proposed authority may provide for the disallowance of a credit for all or a portion of the foreign taxes or for the allocation of the foreign taxes among the participants in the transaction in a manner that is more consistent with the underlying economics of the transaction. The Administration's FY 2005 Budget proposal to expand existing regulatory authority is intended to provide additional mechanisms for Treasury and the IRS to address the second class of transactions described in Notice 98-5 as well as other abusive transactions involving foreign tax credits.

Treasury and the IRS will use existing authority under section 901 and other provisions of the Code to address transactions or structures that produce inappropriate foreign tax credit results. The 2004 business plan for published guidance includes regulations addressing the allocation of foreign taxes by a partnership under section 704. In particular, the regulations will address situations involving special allocations of foreign taxes among the partners that are inconsistent with the allocation of the related foreign income. Treasury and the IRS expect to issue these regulations shortly. Treasury and the IRS also are working on guidance under section 901 concerning the application of the legal liability rule of § 1.901-2(f) in certain circumstances, including, for example, in the case of consolidated tax reporting systems in foreign countries. These regulations are intended to provide rules that make the allocation of foreign taxes imposed on the combined income of two or more persons more consistent with each person's respective share of the foreign income to which the tax relates.

Notice 2004-20, issued concurrently with this notice, identifies as a listed transaction for purposes of the tax shelter

disclosure, registration, and list maintenance regulations a purported stock acquisition that is intended to generate credits for foreign taxes paid on gain that is not subject to tax in the United States. That notice provides that the IRS will challenge the purported foreign tax credit results where a domestic corporation purportedly acquires the stock of a foreign target corporation, makes a 338 election, and then, pursuant to a prearranged plan, sells all or substantially all of the target corporation's assets in a transaction that generates a taxable gain for foreign tax purposes (but not for U.S. tax purposes). Treasury and the IRS also are considering amending § 1.338-9(d) (concerning the allocation of foreign taxes of a target that accrue after the stock acquisition and section 338 election) to address cases in which the target is liquidated (either in a liquidation under local law or by making an election under § 301.7701-3 to treat the target as a disregarded entity) before the end of its foreign taxable year and to address the allocation of foreign taxes imposed on post-acquisition sales in order to prevent inappropriate foreign tax credit results. Treasury and the IRS anticipate that such amendments only would apply prospectively.

In addition, Treasury and the IRS are working on modifications to the tax shelter disclosure regulations of § 1.6011-4(b) (identifying transactions subject to the disclosure requirements) to ensure that the regulations require appropriate reporting of potentially abusive transactions involving foreign tax credits. In particular, Treasury and the IRS are considering revisions to the tax shelter disclosure regulations to require reporting of transactions that effectively separate foreign taxes from the related foreign income, including transactions that create a mismatch in the timing of recognition for U.S. tax purposes of foreign taxes and the related foreign income.

#### EFFECT ON OTHER DOCUMENTS

Notice 98-5 is withdrawn. Notice 2003-76 is modified by eliminating the reference to Notice 98-5 in the identification of listed transactions. Effective for taxable years for which the due date of the return (including extensions, whether or not actually requested) is after February 17, 2004, transactions will not be consid-

ered listed transactions for purposes of §§ 1.6011-4(b)(2) and 301.6112-1(b)(2) solely because they are the same as or substantially similar to the transactions or arrangements described in Part II of Notice 98-5. Effective for offers made after February 17, 2004, transactions will not be considered listed transactions for purposes of § 301.6111-2(b)(2) solely because they are the same as or substantially similar to the transactions or arrangements described in Part II of Notice 98-5. No inference is intended, however, as to whether such transactions are otherwise subject to the disclosure requirements of section 6011, the registration requirements of section 6111, or the list maintenance requirements of section 6112.

#### DRAFTING INFORMATION

The principal author of this notice is Ginny Chung of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Ms. Chung at (202) 622-3850 (not a toll-free call).