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June 28, 2007

CC:PA:LPD:PR (REG-156779-06)  
Courier's Desk  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments on Proposed Regulations §1.901-2(e)(5)(iv)

Ladies and Gentlemen:

The Clearing House Association L.L.C. (“The Clearing House”), an association of major commercial banks,<sup>1</sup> submits this comment letter on Proposed Regulations §1.901-2(e)(5)(iv) (the “Proposed Regulations”) issued on March 29, 2007.<sup>2</sup>

The Proposed Regulations would eliminate the ability of a U.S. taxpayer to claim foreign tax credits for foreign taxes paid in connection with certain types of transactions. The Proposed Regulations accomplish this by treating the amount paid to a foreign country (a “foreign payment”) as being noncompulsory, and therefore not being a foreign tax paid for purposes of the foreign tax credit rules, whenever six conditions are satisfied with respect to the payment.

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<sup>1</sup> The members of The Clearing House are Bank of America, National Association; The Bank of New York; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, National Association; JPMorgan Chase Bank, National Association; LaSalle Bank, National Association; UBS AG; U.S. Bank National Association; Wachovia Bank, National Association; and Wells Fargo Bank, National Association.

<sup>2</sup> Notice of Proposed Rulemaking and Notice of Public Hearing, REG-156779-06, 72 Fed. Reg. 15,081 (March 30, 2007).

This comment letter addresses a limited number of specific issues raised by the Proposed Regulations. In accordance with The Clearing House's policy, these comments reflect the consensus of the members. Individual members of The Clearing House may believe that the Proposed Regulations raise other issues worthy of comment.

### **Summary of Our Comments**

*The Proposed Effective Date.* We explain below why the proposed effective date will have the effect of applying the regulations retroactively and the many reasons why The Clearing House believes that retroactivity would be unfair, inappropriate and potentially detrimental to the integrity of the U.S. Federal tax system.

*The "Taxpayer" For Purposes of the Effective Date.* We explain why we believe that it is clear in the Proposed Regulations that the "taxpayer" whose taxable year is relevant to the effective date is the entity which is liable under foreign law to pay the tax; and why it would be problematic to revise the effective date provision to instead apply to the taxable year of the U.S. person claiming the credit.

*How Non-creditable Foreign Payments Are Treated for Other U.S. Tax Purposes.* If the Proposed Regulations apply to a foreign payment, the payment is not considered a creditable foreign income tax, but it is not clear what the payment is considered and how it is to be treated for other U.S. tax purposes. We describe the possibilities and describe why we believe it should be clarified that the payment is potentially deductible under Section 162 or 212.

*Time When the Six "Conditions" Are Satisfied and Which Tax Payments Are Affected.* The Proposed Regulations are not clear as to *when* the six conditions must be met in order for there to be an "arrangement" to which the Proposed Regulations apply; they are also unclear as to which foreign tax payments are affected by the existence of the six conditions.

We explain why we believe (i) that the Proposed Regulations should apply only during periods all six conditions are met *simultaneously*, (ii) that it is the simultaneous occurrence of the six conditions that causes the "arrangement" to be "described in" the Proposed Regulations, and (iii) that the noncompulsory rule in the Proposed Regulations applies only to foreign payments that are attributable to the assets and activities for which the six conditions are met.

*Specific Questions Pertaining to Conditions #4 and #5.* We point out two aspects of conditions #4 and #5 that we believe are unclear and could become significant points of contention between the IRS and taxpayers if not clarified.

## Detailed Discussion of Our Comments

### I. Proposed Effective Date: Applying the New Rules to the Entire Taxable Year During Which Final Regulations Are Issued

Our first two comments relate to the Proposed Regulations' effective date provision. That provision reads as follows:

[§1.901-2(e)(5)(iv) is] effective for foreign taxes paid or accrued during taxable years of the taxpayer ending on or after the date on which these regulations are published as final regulations in the Federal Register.<sup>3</sup>

We, like many other commentators, believe this proposed effective date is inappropriate and inequitable. Applying these new rules to all taxes accrued during the year in which the regulations are finalized will have the effect of applying them retroactively since, unless the regulations are finalized on the first day of the taxable year, some or all of the actions that caused the foreign payments to accrue during that year will have already occurred. There are significant and compelling reasons not to issue retroactive rules as a general matter; and, in this case specifically, there are additional reasons why retroactive rules would be inappropriate.

One reason why the proposed effective date has generated so much attention and controversy is that a retroactive U.S. Treasury Regulation is such a rarity. In fact, U.S. Treasury Regulations are issued in proposed form in order to give taxpayers notice of the new rules and a fair opportunity to arrange their affairs accordingly (in addition to a right to comment on the regulations) before the new rules are finalized. This procedure is particularly important when the regulations propose significant and new rules, as the Proposed Regulations do.

The benefits of this procedure include not only that it is fair but also that it promotes confidence in and respect for our tax system. Taxpayers arrange their affairs based upon the laws in effect and, in doing so, rely upon the usual procedure under which changes in rules apply prospectively only. The Proposed Regulations propose material changes to well-established rules. If these new rules are applied retroactively, it will undoubtedly introduce uncertainty as to whether in the future other now-well-established rules might also be changed in a "retroactive manner." That type of uncertainty would not be helpful to the integrity of the tax system.

In this case, specifically, retroactivity is particularly troubling. The structures to which the Proposed Regulations apply by definition involve a U.S. person, on the one hand, and one or more unrelated persons, on the other hand, each of which has a significant stake in the structure. Unwinding or restructuring these structures in response to the Proposed Regulation will take some time to complete. Maintaining the proposed "retroactive" effective date would simply be punitive and inequitable.

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<sup>3</sup> Prop. Reg. §1.901-2(h).

The use of a retroactive effective date in this case poses additional, potentially significant, problems for corporations that prepare U.S. GAAP financial statements and must publish their financial statements quarterly. These corporations must apply the law in effect on the last day of the quarter and thus cannot apply the Proposed Regulations to compute their quarterly tax accruals before the regulations are finalized. But once the regulations are finalized, if the regulations apply retroactively, then the corporations will be required to “catch-up” for the prior quarters for which they had applied the old pre-existing law. Therefore, the next quarterly financial statement would reflect a large tax expense for denial of foreign tax credits, likely causing an unexpected fluctuation in that quarter’s earnings as compared to prior quarters and to earnings estimates in the market. Unexpected fluctuations in earnings can have negative repercussions for public corporations, and this would be a particularly unfair result.

## II. Proposed Effective Date: The “Taxpayer” Whose Taxable Year Is Used

The second aspect of the effective date provision that we want to address is the use of the term the “taxpayer.” The provision links the effective date to the taxable year of the “taxpayer.”<sup>4</sup>

These regulations would be added to Reg. §1.901-2. The term “taxpayer” has a well-established definition for purposes of all of Reg. §1.901-2. That definition is found in the currently effective Reg. §1.901-2(f)(1) and is repeated in the proposed “technical taxpayer” regulations (proposed August 4, 2006).

The current regulations provide as follows:

For purposes of this section [*i.e.*, all of Reg. §1.901-2], §1.901-2A and §1.903-1, the person on whom foreign law imposes such liability is referred to as the “taxpayer.”

The August 2006 proposed regulations modify the wording slightly by providing the following:

The person on whom foreign law imposes legal liability is referred to as the “taxpayer” for purposes of this section [*i.e.*, all of Reg. §1.901-2], §1.901-2A and §1.903-1.

The August 2006 proposed regulations also add that generally the foreign law is considered to impose legal liability for the tax on the person who is required to take the income into account for foreign income tax purposes.<sup>5</sup>

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<sup>4</sup> Prop. Reg. §1.901-2(h).

<sup>5</sup> Prop. Reg. §1.901-2(f)(1)(i).

Because the term “taxpayer” is so clearly defined for purposes of Reg. §1.901-2, we believe that the Proposed Regulations clearly refer to the taxable year of the “taxpayer” of the foreign tax -- *i.e.*, the entity which is liable under foreign law to pay the amount. No other interpretation seems appropriate given that these Proposed Regulations are proposed to be a subsection of the very same set of Regulations (Reg. §1.901-2) which so clearly define “taxpayer” as the person liable under foreign law for the payment.

Some have worried<sup>6</sup> that the final version of the Proposed Regulations may include a change to the effective date provision so that it applies based upon the taxable year of the U.S. person who would be eligible to claim the credit. Thus, where the U.S. person is a shareholder of a foreign corporation and thus would be claiming a deemed paid credit pursuant to Section 902 or 960<sup>7</sup> for foreign taxes paid by the foreign corporation, the regulations would be effective for all taxable years of the U.S. person ending (or beginning, if the effective date provision is changed) after the regulations are finalized. The U.S. corporation is clearly “a taxpayer” as that term is used in the Code and defined in Section 7701(a)(14), but it is not the “taxpayer” as that term is used in Reg. §1.901-2.

Because we think the meaning of the term “taxpayer” is clear, if the final regulations modify the effective date language so as to apply the provisions based upon the taxable year of the U.S. person claiming the credits, that would, of course, be a significant change from the Proposed Regulations. Such a change would necessitate prospective application of the finalized regulations in order to be fair.

We would like to emphasize, however, that we believe it would be problematic if the effective date were linked to the taxable year of the U.S. shareholder. One set of problems results from the way in which the Section 902 or 960 deemed paid credit rules operate. When a U.S. shareholder of a foreign corporation receives an actual or deemed distribution, the amount of the Section 902 or 960 credit attached to the distributions is determined (in most cases) by reference to the pool of the taxes paid by the foreign corporation and not yet deemed distributed to shareholders from 1987 to the present date. If the new effective date applied the regulations to any credits claimed by a U.S. shareholder after the regulations are finalized, that would potentially include taxes paid over the last 20 or more years, which is quite a far-reaching retroactive period and raises all the tax policy concerns that retroactivity raises.<sup>8</sup>

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<sup>6</sup> See, e.g., “Government Officials Discuss Foreign Tax Credit Generator Regs”, Tax Notes Today (May 16, 2007); “Government Said to Be Working to Maintain Balance in Foreign Credit Generator Rules”, Daily Tax Reporter (May 16, 2007).

<sup>7</sup> All “Section” references are to sections of the Internal Revenue Code of 1986, as amended (the “Code”).

<sup>8</sup> If the foreign corporation still has undistributed credits for foreign taxes paid before 1987, those could also be impacted and disallowed under such a rule. Under Section 902, the post-1986 pools of earnings and taxes are distributed or deemed distributed first, but once those pools are reduced to zero, distributions start to come out of pre-1987 earnings and foreign taxes.

The U.S. shareholder would also have the (potentially insurmountable) administrative burden of determining whether these six, newly-identified conditions were met at any time during that 21-year period (or perhaps an even longer period).

Another problem is that it would be unclear how the six-condition test is supposed to be applied in such a scenario -- would it apply to the year the tax payment accrued or to the year the U.S. person claimed the credit?

It would make far more sense to follow the approach in the current version of the Proposed Regulations -- by testing the payment at the payor (the taxpayer of the foreign tax) level and testing the payment at the time the tax is paid or accrued, and then, if the tax is a "tax paid" under the Proposed Regulations, adding it to the foreign corporation's pool of paid but undistributed taxes.

### **III. How Are the Foreign Payments that Are Covered by the Proposed Regulations Treated for Other U.S. Federal Tax Purposes**

The Proposed Regulations state that if the six conditions are met an amount paid to a foreign country (a "foreign payment") is considered a noncompulsory payment and thus is "not an amount of tax paid." This makes it clear that the "foreign payment" is not a creditable "foreign tax" under Section 901, but it leaves unclear precisely how the payment is to be treated for other U.S. Federal tax purposes.

Section 164(a)(3) provides that foreign income taxes are deductible, but Section 275(a)(4) provides that a taxpayer must choose each year to claim either a foreign tax credit under Section 901 or a deduction for foreign income taxes under Section 164. A taxpayer that claims the Section 901 credit is permitted to deduct, under Section 164(a), any foreign tax that is not an income tax (and would otherwise qualify as a Section 162 or Section 212 deduction). A taxpayer is also permitted to deduct expenses that are not taxes at all if they qualify as ordinary and necessary trade or business expenses under Section 162 for the taxpayer or Section 212 expenses incurred for the production of income. Finally, an out-of-pocket expense that is not deductible will still reduce the current earnings and profits of a corporate taxpayer (or the outside tax basis for a partner where the payor is a partnership).

The Proposed Regulations indicate only that the foreign payment is "not an amount of tax paid." It is not clear if this proposed rule -- that the payment is not considered a "payment" of a "tax" -- is only for Section 901 purposes, or also governs the treatment of the payment under other sections of the Code and the Regulations. The possibilities are as follows:

- The foreign payment is treated as a foreign income tax for all purposes other than Section 901. In that case, Section 275(a)(4) would apply with the result that (if the taxpayer claimed a foreign tax credit for other taxes in that year) this foreign payment would be neither creditable nor deductible.

- The foreign payment is treated as a foreign tax, but not an income tax. In that case, the payment would be deductible under Section 164 (even if the U.S. person claimed the Section 901 credit in that same year for other foreign income taxes).
- The foreign payment is treated as not being a tax at all. In that case, the payment would be eligible to be deductible under Section 162 or 212 (subject to the other requirements of those sections being met).
- The foreign payment is treated as “not an amount paid” at all (as opposed to be treating as an amount that was paid, but not an amount of tax paid). In that case, it would have no tax impact -- it would not even reduce earnings and profits or basis.

The Clearing House believes that the effect of the Proposed Regulations would be to make the payments not a “tax” at all, but that the payments would still be respected as an expenditure, and therefore potentially deductible under Section 162 or 212. We request that this be clarified.<sup>9</sup>

If, notwithstanding the compelling arguments in favor of revising the proposed effective date so that it is not retroactive, the regulations are finalized and made effective back to the first day of the year in which finalized, we submit that it would be appropriate to clarify that, because the foreign payment is not a “tax paid,” it is treated as a non-tax expense eligible for deduction under Section 162 or 212 and that the IRS will not challenge the deduction on the grounds that the expenditure was not “ordinary and necessary.”

This type of approach was used first in Section 901(k) and then repeated in Section 901(l) for the very reason that the expenditures are in fact out-of-pocket costs and therefore offsets to income, even if the Government has made a judgment that they should not be eligible for the Section 901 or 902 credit.

#### **IV. Time When the Six “Conditions” Are Satisfied and Which Tax Payments Are Affected**

The Proposed Regulations are not clear as to *when* the six conditions must be met in order for there to be an “arrangement” to which the Proposed Regulations apply; they are also unclear as to which foreign tax payments are affected by the existence of the six conditions.

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<sup>9</sup> We believe that this could be clarified in the regulations themselves. The similar Sections 901(k) and 901(l) were necessary within the Code because in those situations it was a provision of the Code (not regulations) that caused the foreign income tax to be noncreditable. In this case, it is a regulation that is providing that the foreign payment will not be treated as a foreign income tax, and that very same regulation could provide that the foreign payment is treated as a non-tax payment for Section 275(a)(4) purposes.

The Proposed Regulations provide that a foreign payment is not treated as an amount of tax paid if the foreign payment is “attributable to an arrangement described in” Prop. Reg. §1.901-2(e)(5)(iv)(B).<sup>10</sup> The Proposed Regulations then provide that an arrangement is “described in” Prop. Reg. §1.901-2(e)(5)(iv)(B) if six conditions are “satisfied” with respect to that arrangement.

A foreign payment is “attributable to” such an arrangement if the foreign payment is described in the second condition (Prop. Reg. §1.901-2(e)(5)(iv)(B)(1)(ii)), which means that at a minimum the foreign payment is “attributable to” income of the entity that qualifies as the arrangement’s special purpose vehicle or “SPV” (or a pass-through subsidiary of the SPV).

If all six conditions are met at all times, there is clearly an “arrangement.” But there may be other possibilities:

- In a specific tax year, some of the six conditions are met on some of the days and the remainder of the six are met on other days.
- In any specific tax year, all six conditions are met on some days of the year but not on other days.
- All six conditions are met during one tax year but not during the next tax year.

Relatedly, the six conditions may be met for a portion of an entity’s activities, but that same entity may conduct other activities for which the conditions are not met.

We believe (i) that the Proposed Regulations are intended to apply only if all six conditions are met *simultaneously*, (ii) that it is the simultaneous occurrence of the six conditions that causes the “arrangement” to be “described in” the Proposed Regulations, and (iii) that the noncompulsory rule in the Proposed Regulations applies only to foreign payments that are attributable to the assets and activities for which the six conditions are met. Thus, if an entity has one set of assets and activities for which the six conditions are met, the Proposed Regulations apply to the foreign payments that are attributable to those assets and activities, for the period during which all six conditions were met. There is not, we believe, a broader taint or a permanent taint -- thus, other periods when all six conditions are no longer met are not impacted, and other assets and activities, even if held by that same “taxpayer,” are not impacted.

We considered whether the Proposed Regulations should have, or could be interpreted as having, a “once-an-arrangement, always-an-arrangement” rule. We believe such a rule would be illogical, unfair and unadministrable.

For example, suppose there is “an arrangement” and the U.S. person purchases the foreign counterparty’s interest, leaving the U.S. person as the sole owner. Instead of

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<sup>10</sup> Prop. Reg. §1.901-2(e)(5)(iv)(A).

dissolving the entity that was the “SPV,” the U.S. person wants the SPV to continue to hold the assets so that it may continue using them in its business or for some other purpose. Alternatively, in a jurisdiction where forming and qualifying an entity is time-consuming, recycling an entity may provide cost or other advantages.

If the final regulations were to adopt a rule that said that once an SPV was part of an arrangement it would forever more be treated as part of an arrangement, it would mean that a U.S. person could never use an “ex-SPV” in any of these ways. It would also mean that every time a U.S. person was considering purchasing a foreign entity the U.S. person would need to do significant due diligence and would want a representation and indemnity from the seller that the foreign entity was, at no time in its history, an SPV that was part of an “arrangement.” A seller, particularly a non-U.S. seller, is unlikely to be willing to give such a representation or indemnity.

A foreign entity (“entity 1”) that is purchasing another foreign entity (“entity 2”) would, if well advised, want that same representation and indemnity. This is because entity 1 may some day want to sell entity 2 to a U.S. person, or entity 1 may some day find itself being acquired by a U.S. person.

Moreover, there seems to be no policy rationale or other purpose satisfied from applying a “permanent taint” to an SPV once the six conditions cease to be met.

For similar reasons, we believe that the “arrangement” referred to in the Proposed Regulations means the assets and activities for which and during the time which the six conditions are simultaneously met -- and that the existence of an arrangement within an entity does not “infect” the entire entity. There is no rationale for treating every foreign tax that an entity pays as “noncompulsory” simply because one stream of taxes that it pays is deemed to be “noncompulsory.”

## **V. Specific Questions Pertaining to Conditions #4 and #5**

Our final two comments relate specifically to conditions #4 and #5. Condition #4 provides as follows:

the arrangement is structured in such a manner that it results in a foreign tax benefit (such as a credit, deduction, loss, exemption or a disregarded payment) for a counterparty described in paragraph (e)(5)(iv)(B)(5) of this section or for a person that is related to the counterparty (determined under the principles of paragraph (e)(5)(iv)(C)(6) of this section by applying the tax laws of a foreign country in which the counterparty is subject to tax on a net basis) but is not related to the U.S. party (within the meaning of paragraph (e)(5)(iv)(C)(6) of this section).<sup>11</sup>

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<sup>11</sup> Prop. Reg. §1.901-2(e)(5)(iv)(B)(4).

It is not clear whether this means (1) that the unrelated counterparty in fact obtains such a foreign tax benefit, (2) that the persons who structured the arrangement did so with the intent that the unrelated counterparty obtain such a foreign tax benefit, or (3) that both of these must be true.

We raise this point simply because it seems to us that this could become a significant point of contention between the IRS and taxpayers and it is not clear to us how either party could conclusively determine or prove that the condition as worded is or is not met.<sup>12</sup>

We believe that the second interpretation is more consistent with the intent of the Proposed Regulations and far more administrable. The requirement could be considered met if the U.S. person was aware of the intended or expected benefit such that it was taken into account during the negotiations of the terms and structure of the arrangement.

*Condition #5:*

The second alternative under this condition is that the counterparty is treated under foreign tax law as acquiring, directly or indirectly in one transaction or a series of transactions, 20% or more of the SPV's assets. What is intended by this second alternative and how it could be applied seems unclear. For example, how could both the SPV and the unrelated counterparty be treated as owning the assets at the same time? Or, is this test supposed to be considered met if the acquisition occurs at any time? If the unrelated counterparty purchases the SPV's assets in the course of winding up the arrangement in Year 10, does that taint the arrangement for all of Year 10? For Years 1 through 9? Clarification of how this condition is applied would be helpful.

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<sup>12</sup> For example, if an actual foreign benefit is what is required, then a series of problems arises: How does the U.S. person determine whether the unrelated counterparty is claiming such a benefit? How does the U.S. person determine whether the claim to such a benefit was sustained with the foreign taxing authority? How can the U.S. person determine how to file its U.S. return before the unrelated counterparty's foreign claimed benefit has been finally upheld or finally denied (or even initially claimed)? If the U.S. person claimed the requirement was not met, how would the IRS investigate if the foreign counterparty was outside the reach of U.S. subpoena power? What if the foreign taxing authority challenged the counterparty's claim, but the matter was settled in the context of a larger audit where there may have been some trading between claims?

The Clearing House appreciates your consideration of these comments. If you have any questions or if the members of The Clearing House can assist you in considering these important issues, please contact Norman R. Nelson, General Counsel of The Clearing House, at (212) 612-9205.

Very truly yours,

A handwritten signature in black ink, appearing to read "N. Nelson", with a horizontal line underneath.

cc: Benedetta Kissel  
Steve Musher  
Barbara Felker  
John Harrington  
Bethany Ingwalson