INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 901.00-00, 701.00-00
CASE-MIS No.: TAM-130972-06

Territory Manager

Taxpayer Names:

Taxpayer Addresses:

Taxpayers Identification Nos.:

Years Involved:

Dates of Conferences:

LEGEND:

US Group	=	
US Corp	=	
US Sub	=	
Transferee	=	
UK Parent	=	
UK Sub1	=	
UK Sub2	=	
Issuer	=	
Subsidiary	=	
Promoter	=	
Instrument	=	
Senior Loan Document	=	
Subscription Agreement	=	
Deed of Covenant	=	
Articles of Association	=	
$a	=	
$b	=	
$c	=	
$d	=	
$e	=	
$f	=	
$g	=	
$h	=	
$i	=	
$j	=	
$k	=	
$l	=	
$m	=	
$n	=	
$o	=	
$p	=	
$q	=	
$aa	=	
$bb	=	

$cc	=
$dd	=
$ee	=
$ff	=
$gg	=
$hh	=
$ii	=
$jj	=
$kk	=
$ll	=
$mm	=
$nn	=
$oo	=
$pp	=
$qq	=
$rr	=
$ss	=
$tt	=
$uu	=
$vv	=
$ww	=
$xx	=
r%	=
s%	=
t %	=
u%	=
v%	=
w%	=
x%	=
y%	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Year 1	=
Year 2	=
Year 3	=

ISSUES:

1. Whether US Group and Transferee (collectively, "Taxpayers") are precluded from claiming foreign tax credits under section 901 for payments to the United Kingdom (U.K.) in respect of Subsidiary's income because those payments are noncompulsory amounts under Treas. Reg. §1.901-2(e)(5)?

2. Whether Taxpayers are precluded from claiming foreign tax credits under section 901 for payments to the U.K. in respect of Subsidiary's income because Taxpayers' investment in the securities issued by Issuer is a loan for U.S. tax purposes, not an equity investment?

3. Whether the anti-abuse provision under Treas. Reg. §1.701-2 applies to disallow the foreign tax credits claimed by Taxpayers in connection with the transaction because they result from a partnership investment which has as its principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K?

4. Whether the foreign tax credits claimed by Taxpayers should be disallowed because the transaction generating the foreign tax credits lacked economic substance?

CONCLUSIONS:

1. Issuer failed to apply the substantive and procedural provisions of U.K. law in a manner that minimized its U.K. tax obligations because Issuer failed to surrender its losses to Subsidiary (a disregarded entity for U.S. tax purposes) as permitted by the U.K. group relief regime. Payments to the U.K. in respect of Subsidiary's income are noncompulsory payments under Treas. Reg. §1.901-2(e)(5) to the extent those payments exceed the amount of U.K. tax that would have been due if Issuer and Subsidiary had elected to surrender Issuer's losses to Subsidiary. The noncompulsory payments are not taxes paid for purposes of section 901 and Taxpayers are not eligible to claim credits under section 901 for such payments.

2. Alternatively, Taxpayers are not entitled to claim credits for the purported payments of U.K. tax because the securities of Issuer are debt instruments, not equity, for U.S. tax purposes or are like debt instruments under U.S. tax principles. Therefore, US Sub and Transferee (collectively, "Holders") are not partners of Issuer and Taxpayers cannot claim credits pursuant to sections 702(a) and 901(a) for any U.K. taxes paid by Issuer. For U.S. tax purposes, Issuer is a branch or division of its sole owner, UK Sub1. Holders are considered to hold debt or debt-like instruments of UK Sub1 and to receive interest from UK Sub1 in the amount of the distributions on the securities of Issuer.

Alternatively, Issuer and Subsidiary are mere conduits and the substance of the transaction is a loan from Holders to UK Parent. Therefore, Holders are not partners of Issuer and Taxpayers cannot claim credits pursuant to sections 702(a) and 901(a) for

any U.K. taxes paid by Issuer. For U.S. tax purposes, Holders are considered to hold debt of UK Parent and to receive interest from UK Parent in the amount of the distributions on the securities of Issuer.

3. Alternatively, the anti-abuse rule in Treas. Reg. §1.701-2 applies to the transaction and requires recharacterization of the transaction as a loan from Holders to UK Parent. Therefore, Holders are not partners of Issuer and Taxpayers cannot claim credits pursuant to sections 702(a) and 901(a) for any U.K. taxes paid by Issuer. For U.S. tax purposes, Holders are considered to hold debt of UK Parent and to receive interest from UK Parent in the amount of the distributions on the securities of Issuer.

4. Alternatively, the transaction generating the foreign tax credits lacked economic substance. Therefore, the foreign tax credits must be disallowed. However, Taxpayers did invest \$c and must include in income an amount equal to the cash distributions received by Taxpayers.

FACTS:

Taxpayers are US Group, a U.S. consolidated group, and Transferee, a non-consolidated domestic corporation controlled by US Group. Three taxable years are at issue.

1. The Transaction

UK Parent is a U.K. corporation that wholly owns UK Sub1 and UK Sub2. UK Sub1 and UK Sub2 are also U.K. corporations. On Date 1, UK Sub1 formed Issuer by contributing \$a to Issuer in exchange for 100 percent of Issuer’s ordinary shares. UK Sub1 also loaned \$b to Issuer. Issuer is a U.K. entity that is a corporation for U.K. tax purposes. Taxpayers take the position that Issuer is a partnership for U.S. tax purposes.

US Corp is a domestic corporation that wholly owns US Sub, also a domestic corporation. US Corp and US Sub are members of US Group. On Date 2, US Sub used \$c contributed to it by US Corp to purchase non-convertible securities (the “Securities”) issued by Issuer and evidenced by the Instrument. The \$c purchase price was equal to r% of the combined amount of the Securities and Issuer’s ordinary shares (i.e., \$c = r% of \$a + \$c). UK Parent and Issuer treated the Securities as debt for U.K. tax and accounting purposes. Taxpayers take the position that the Securities are equity interests in Issuer (i.e., partnership interests) for U.S. tax purposes. Yield payments on the Securities and other key terms relating to the Securities are discussed in section 2 below.

Issuer capitalized Subsidiary by contributing \$d (\$a + \$c) to Subsidiary in exchange for 100 percent of the ordinary shares of Subsidiary and by loaning the remaining \$b of its funds to Subsidiary. Subsidiary is a U.K. entity that is treated as a corporation for U.K.

purposes. An election was made to treat Subsidiary as a disregarded entity for U.S. tax purposes.

Subsidiary, in turn, loaned the entire amount of funds it received from Issuer ($e) to UK Parent. UK Parent used the loan proceeds to retire existing indebtedness.

The loan to UK Parent (the "Senior Loan") was a callable, perpetual (i.e., no fixed maturity date), fixed rate loan that paid s% quarterly. The s% was the five-year fixed equivalent rate of US$LIBOR. The due dates for the interest payments on the Senior Loan coincided with the due dates of the yield payments on the Securities. In the Instrument, Issuer covenanted that it would cause Subsidiary to call the Senior Loan in the event of a redemption of the Securities or upon the calling of an auction with respect to the Securities. Instrument, Art. 7(2)(s)(iii),(iv). Under the terms of the Instrument, the calling of the Senior Loan pursuant to an auction would trigger a liquidation of Issuer and, thus a redemption of the Securities, unless Issuer entered into a replacement senior loan facility. See below under "Liquidation of Issuer." Upon any redemption of the Securities, Issuer was required to use the proceeds from the Senior Loan to repay the holder(s) of the Securities. Instrument, Art. 7(1)(u). The proceeds from the Senior Loan exceeded the price to redeem the Securities by a ratio of 1.22:1 (hereinafter, "over-collateralization"). US Group's Transaction Approval Document (Exhibit 5 to the TAM Submission) indicated that the over-collateralization substituted for UK Parent's guarantee.

US Corp entered into a five-year interest-rate swap agreement with UK Sub2. US Corp agreed to pay UK Sub2 s% quarterly. UK Sub2 agreed to pay US Corp three-month US$LIBOR flat on a notional amount of $c. The swap agreement effectively fixed US Group's return at an amount equal to three-month US$LIBOR minus 100 basis points (i.e., s% -u% = 100 basis points). In the three taxable years at issue, the swap resulted in no payments in the first year and in a net payable from US Corp in years two and three.

Transferee was formed on Date 3. On Date 4, US Sub transferred the Securities to Transferee in exchange for the common stock of Transferee. At the time of the transfer, US Group was in an excess foreign tax credit position according to US Group's return as filed. The Securities were transferred to Transferee to allow current utilization of the foreign tax credits claimed in connection with the Securities. Absent the transfer, the credits were projected to be fully utilized before any expiration. The transfer did not affect the terms of the transaction.

In accordance with terms of the Instrument, Issuer redeemed the Securities on Date 6, approximately five years after the issuance of the Securities, for the principal amount of $c plus accrued, but unpaid, yield payments.

2. Key Terms

Yield Payments. The Instrument required Issuer to make payments ("Yield Payments") on the Securities at the end of each calendar-year quarter. Subject to the occurrence of an auction (discussed below), the rate was t% for the first year and u% for years two through five, ending on Date 6. Instrument, Art. 5(1).

The Instrument provided for adjustments in the amount of the Yield Payments in the event of a change in the rate of the U.K. corporation tax to which the income of Subsidiary was subject. The adjustments to the Yield Payments bore an inverse relationship to changes in the rate. Instrument, Art. 6(4).

The Instrument permitted Issuer to defer Yield Payments by extending the Yield Payment period, but provided that Issuer could not defer the first Yield Payment beyond Date 5, a date one year after the issuance of the Securities. Instrument, Art. 5(6). Deferred Yield Payments accrued interest, compounded quarterly at the applicable Yield Payment rate. Id. Failure to make a Yield Payment prior to Date 5 would trigger a liquidation of Issuer. Failure to make Yield Payments for any four consecutive quarters would also trigger a liquidation of Issuer. See "Liquidation of Issuer" below.

The Instrument required suspension of Yield Payments if Issuer became insolvent or failed to satisfy either a minimum net worth test or an earnings and profits test. The Instrument defined solvency as the Issuer being able to pay liabilities as they came due and having book assets in excess of book liabilities (not treating the Securities as liabilities). To meet the minimum net worth test, the book value of Issuer's assets had to exceed 101% of the book value of its liabilities (treating the Securities as liabilities for this purpose). To meet the earnings and profits test, Issuer had to have current or accumulated earnings and profits (as determined for U.S. tax purposes) at least equal to the Yield Payments due for the yield period. The Instrument provided that interest would not accrue on suspended Yield Payments. Instrument, Art. 5(5).

Auction Procedures. The Instrument included auction provisions that allowed holders to change the yield on the Securities. An auction could take place at the following times. First, the Instrument required Issuer to initiate auction proceedings 10 days before Date 6, approximately five years after the issuance of the Securities. Instrument, Art. 5(2)(a). Second, the holder(s) of $100 million of the Securities could demand an auction at any time after Date 5, a date one year after the issuance of the Securities. Instrument, Art. 5(7)(iii). Other events triggering an auction at the option of holder(s) of $100 million of the Securities included: (1) a change in any law at any time resulting in a material decrease in the economic benefits or a material increase in the costs of the Securities for the holder, the Issuer or their affiliates; (2) US Corp's receipt of a notice, at any time, terminating the interest-rate swap; or (3) a decrease or a more than five percent increase in the U.K. tax rate imposed on the interest income of Subsidiary. Instrument, Art. 5(7)(i).

Schedule 2 of the Instrument set forth procedures for the auction to determine the yield at which the holder would be willing to continue to hold the Securities or at which others would want to invest in the Securities. An auction agent would conduct the auction. The Instrument required the agent to contact up to six persons to determine if they would be willing to submit a bid to purchase the Securities (i.e., to submit a rate at which they would be willing to purchase the Securities). Instrument, Sch. 2, Art. 2(i). Under the Instrument, the existing holder of the Securities (as well as any other bidder) had the right to bid a rate, which the existing holder (or other bidder) "in its absolute discretion" considered to be a reasonable rate of return on the Securities. Instrument, Sch. 2, Art. 2(ii). Thus, the auction procedures did not set a maximum bid.

The new yield would be set at the lowest rate that would result in a number of successful bids equal to the amount required to ensure that the total amount of outstanding Securities would continue to be held by existing holders or would be sold to the other bidders. If the existing holder's bid was higher than the new yield, the Instrument required the existing holder to sell its Securities at the Redemption Price (defined below under "Redemption") to a person that had bid the new yield. Instrument, Sch. 2, Art. 5. In addition, if Issuer believed that the new yield exceeded a reasonable commercial return on the Securities, Issuer had the right to redeem the Securities at the Redemption Price. Instrument, Sch. 2, Art. 4(iii).

In its analysis of the transaction, US Group cited this as a tactic it could use to "engineer its exit" of the transaction and one that limited US Group's exposure to any credit risk that UK Parent may have posed. The Credit Approval Report states the following:

> Twelve months after the issuance of the Securities, [US Corp] has an unfettered right to request [Issuer] to hold an auction of the Securities. [US Corp] is obliged to bid for the whole of the Securities at the rate it deems reasonable in its sole discretion. If [Issuer] is not satisfied with the outcome of the bids, it can procure that the Senior Loan (which is repayable on 5 business days notice) be repaid in order to permit the redemption of the Securities at par value plus any accrued or deferred yield payments. If [US Corp] decides that it no longer wishes to invest in the Securities, and thus bids a sufficiently high rate in any auction, then the issuer of the Securities should have an economic compulsion to redeem or transfer the Securities to other bidders. Therefore we take the view that the exposure to the Securities can be considered short-term. Five years after the issuance of the Securities, an auction will be held to reset the rate to either fixed or floating. If the bids received by [Issuer] are too high, [Issuer] can give a notice of redemption of the Securities at par plus any accrued yield payment.

As a result of Issuer's redemption of the Securities, auction procedures were never initiated and no auction ever occurred.

Status and Subordination. The Securities were subordinate to all liabilities of Issuer and senior to any class of Issuer's ordinary shares. Instrument, Art. 3(1).

No Voting Rights. The Securities were non-voting. However, holders of the Securities did have the right to vote at meetings of holders relating to the acceptance or rejection by the holders of substitute securities or modifications to the Securities proposed by Issuer. Instrument, Sch. 3, Art. 16. We understand that no such meetings were ever held.

Redemption. The Instrument provided for the redemption of the Securities under certain circumstances at a price equal to the principal of the Securities, plus accumulated and unpaid, suspended and deferred Yield Payments (including accrued interest thereon) to the date fixed for redemption (the "Redemption Price").

Such circumstances included the following. First, the Instrument permitted Issuer to redeem the Securities at any time: (1) on or after Date 5, a date one year after the issuance of the Securities; (2) following a change in any law resulting in a material decrease in the economic benefits or a material increase in the costs of the Securities for the holder, the Issuer or their affiliates; or (3) following receipt by UK Sub2 of a notice terminating the interest-rate swap. Instrument, Art. 4(2). Second, the Instrument permitted Issuer to redeem the Securities if the Issuer determined that it had to pay holders "additional amounts" as a result of a change in the law of the U.K. or a change in any treaty to which the U.K. was a party. Instrument, Art. 4(3)(a). The Instrument defined "additional amounts" as additional amounts due to the holders of the Securities to make the holders whole in the event the Yield Payments became subject to U.K. withholding tax. Instrument, Art. 6.

The Instrument conditioned redemption upon "adjusted net capital" equaling or exceeding the Redemption Price. Instrument, Art. 4(4). Adjusted net capital was defined as the book value of Issuer's assets, including accrued income, less any liabilities, accrued expenses (if any) or other non-share claims (i.e., liabilities other than those owed to shareholders in their capacity as such), excluding the Redemption Price of the Securities.

Liquidation of Issuer. The Articles of Association of Issuer included several events that would trigger a liquidation of Issuer ("Liquidation Events"). Articles of Association, Art. 30. The first event was Issuer's failure to make at least one Yield Payment prior to Date 5, the first anniversary of the issuance of the Securities. The second was Issuer's failure to make Yield Payments for any four consecutive quarters. The third was Issuer's breach of any covenant in the Instrument or the Subscription Agreement, including a failure to pay the full Redemption Price when due. The fourth was any event of default as defined in the Senior Loan Document. That document set forth 11 events of default, including UK Parent's failure to pay, timely and in proper currency, any

amount for which it is liable under the Senior Loan Document.[1] Thus, any single failure to pay by UK Parent was a liquidation event. The fifth event of liquidation under the Instrument was, in pertinent part, any institution of bankruptcy or insolvency proceeding against or involving Issuer, Subsidiary, UK Parent, or other defined entities. The final event of liquidation was the date falling 10 business days after the calling of the Senior Loan by Subsidiary pursuant to clause 7(2)(s)(iv) of the Instrument, unless prior to such date Subsidiary and UK Parent entered into a "replacement senior loan facility" and Subsidiary has advanced a loan thereunder.[2]

The Articles of Association of Issuer provided that upon the occurrence of a Liquidation Event, the members of Issuer "shall jointly and severally be obliged to requisition a meeting of members of the company for the purpose of passing a winding-up resolution, and to vote in favor of a winding-up resolution." Articles of Association, Art. 30. UK Sub1, which owns all of the voting interests in Issuer, agreed in the Deed of Covenant that upon the occurrence of a Liquidation Event, it would call a general meeting of the Issuer and vote its shares in favor of winding up Issuer. Deed of Covenant, Art. 3; TAM Submission, p. 38.

Permitted Assets and Liabilities. The Instrument limited Issuer's permitted assets ("Issuer Permitted Assets") to the equity share capital in Subsidiary of $d, plus the $b loan to Subsidiary, for a total of $e. Issuer's permitted liabilities ("Issuer Permitted Liabilities") were limited to (1) liabilities to Subsidiary; (2) liabilities under the $b loan from UK Sub1 to Issuer; (3) other liabilities to UK Parent and its affiliates, subject to an aggregate cap discussed below; and (4) liabilities in respect of taxation, accounting, legal, and other administrative expenses, subject to an aggregate cap discussed below.

The Instrument limited Subsidiary's permitted assets ("Subsidiary Permitted Assets") to the following: (1) US$-denominated debt securities of a G-7 sovereign issuer or any supra-national or corporate issuer if rated not lower than Aa3/AA by Moody's or S&P; (2) US$-denominated A1/P1 commercial paper and similar highly-rated money-market instruments; (3) cash and cash equivalents (denominated in U.S. dollars, with minor exceptions), including deposits with banks rated at least Aa2/AA; (4) the Senior Loan; (5) loans to Issuer in the event Issuer lacks sufficient funds to make payments in respect of the Securities; and (6) on-demand loans to UK Parent or other members of its group, as long as Yield Payments were current and there was no event of default under the Senior Loan (discussed below). Although Subsidiary was authorized to

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[1]This provision granted a grace period of seven days in which UK Parent could remedy a failure to pay, but only if "technical or administrative error" caused the failure.

[2]Clause 7(2)(s)(iv) of the Instrument required Issuer to call the Senior Loan upon the calling of an auction with respect to the Securities. The Instrument defines the term "replacement senior loan facility" as a loan agreement between Subsidiary and UK Parent under which Subsidiary agrees to advance to UK Parent or to another member of the UK Parent group (subject to the provision of a guarantee from UK Parent on terms previously approved in writing by the holders of the Securities) a loan of at least $e upon terms which, in all material respects, are the same as those of the Senior Loan or, if different, upon terms which have been approved in writing by the holders of the Securities.

provide funding to UK Parent and certain of its affiliates and to make certain other highly rated investments, the Senior Loan exhausted Subsidiary's available assets and the Senior Loan was Subsidiary's sole activity.

The Instrument limited Subsidiary's permitted liabilities ("Subsidiary Permitted Liabilities") to the following: (1) liabilities to UK Parent under the Senior Loan, including a "funding loan" not relevant here; (2) U.K. taxes on interest received under the Senior Loan or in respect of other Subsidiary Permitted Assets; (3) liabilities to Issuer in respect of declared dividends and the $b loan from Issuer to Subsidiary; (4) any liabilities incurred in respect of taxation, accounting, legal, and other administrative expenses, subject to an aggregate cap discussed below; and (5) foreign exchange losses relating to U.K. tax liabilities, subject to an aggregate cap discussed below.

The Instrument imposed an aggregate cap of $f (.5% of the Senior Loan to UK Parent) for the following liabilities of Issuer and Subsidiary: (1) Issuer liabilities to UK Parent and its affiliates; (2) liabilities of Issuer and Subsidiary in respect of taxation, accounting, legal, and other administrative expenses; and (3) foreign exchange losses of Subsidiary relating to U.K. tax liabilities.

In its analysis of the risk of the transaction, US Group cited the restrictions on permitted assets and permitted liabilities of Issuer and Subsidiary as factors intended to minimize credit risk and ensure that interest income on the Senior Loan is used to make Yield Payments on the Securities. Credit Approval Report (Exhibit 4 to the TAM Submission).

Covenants. The Instrument set forth covenants relating to both Issuer and Subsidiary. Instrument, Art. 7. Issuer covenanted, inter alia, that:

1. Issuer would not dispose of any shares in Subsidiary;
2. Issuer would use $d from UK Sub1 and US Sub to capitalize Subsidiary and would use $b from UKSub1 to make a loan of $b to Subsidiary;
3. Issuer would not voluntarily liquidate, except pursuant to a Liquidation Event (described above) or as required by law or in accordance with the fiduciary duties of the directors of Issuer;
4. Issuer would not create or allow any security interest over any of its revenues or assets;
5. Issuer would not enter any business or trading activity other than the holding and servicing of Issuer Permitted Assets and Issuer Permitted Liabilities and would not have any subsidiaries (other than Subsidiary) or employees, purchase, own, lease or otherwise acquire any real property (including office space) or enter into any securities lending transactions;
6. Issuer would not incur any liabilities except Issuer Permitted Liabilities;
7. Issuer would not make any loans other than the $b loan to Subsidiary;
8. Issuer would not make any investments other than in Issuer Permitted Assets;

9. Issuer would use the proceeds received from Subsidiary, upon the repayment of the Senior Loan, to redeem the Securities immediately upon receipt of the proceeds;
10. For U.S. tax purposes, Issuer would treat itself as a partnership and would treat the holder of the Securities and the holder of the ordinary shares as partners in the partnership;
11. Issuer would allocate 99% of all items of income, gain, loss, deductions and credits to the holder(s) of the Securities and 1% to the holder of the ordinary shares, until the total net income and gain allocated to holder(s) of the Securities equaled the Yield Payments accrued to such holder(s) during that year (whether or not paid) divided by one minus the U.K. tax rate; and thereafter would allocate 1% of the items to the holder(s) of the Securities and 99% to the holder of the ordinary shares;
12. Issuer would make all allocations in accordance with § 704(b);
13. Issuer would complete its U.K. tax return reporting dividends and interest from Subsidiary as its only income or profit, and Yield Payments, interest paid to UKSub1 on the $b loan, and Issuer Permitted Liabilities as its only expense; and
14. Issuer would notify the holder(s) of the Securities promptly of any change in U.K. tax law that would require Issuer to take a different position on its U.K. tax return.

With respect to Subsidiary, Issuer covenanted it would exercise its rights as shareholder of Subsidiary to procure, inter alia, that:

1. Subsidiary would pay dividends to Issuer on the last day of each quarter;
2. Subsidiary would not create or allow any security interest over any of its revenues or assets;
3. Subsidiary would not voluntarily liquidate;
4. Subsidiary would not enter any business or trading activity other than the holding and servicing of Subsidiary Permitted Assets and Subsidiary Permitted Liabilities and would not have any subsidiaries or employees, purchase, own, lease or otherwise acquire any real property (including office space) or engage in any securities lending transactions;
5. Subsidiary would not incur any liabilities except Subsidiary Permitted Liabilities;
6. Subsidiary would not make any loans, other than the Senior Loan, or become a creditor unless that transaction was a Subsidiary Permitted Asset;
7. Subsidiary would not make any investments other than in Subsidiary Permitted Assets;
8. Subsidiary would pay U.K. tax timely;
9. Subsidiary would not claim group relief from any member of the UK Parent group relief group for the Subsidiary's accounting periods in which the Securities remain outstanding.
10. Subsidiary would elect to be treated as a branch for U.S. tax purposes;
11. Subsidiary would report the following items on its U.K. tax return:

a. Income or profit limited to interest on the Senior Loan, which accrued at s%; income from other Subsidiary Permitted Assets; and a maximum of $1,000,000 in foreign exchange profits;
b. Expenses solely of Subsidiary Permitted Liabilities and interest on the $b loan, which accrued at s%;

12. Subsidiary would notify the holder(s) of the Securities promptly of any change in U.K. tax law that would have required Subsidiary to take a different position on its U.K. tax return;
13. Subsidiary would invest all of its $e cash in advancing the Senior Loan;
14. Subsidiary would not agree, without prior approval of the holders of not less than 50% of the aggregate principal amount of Securities then outstanding to waive, amend, modify and/or terminate the Senior Loan or any other loans to or contracts with other affiliates;
15. Subsidiary would require UK Parent to repay the Senior Loan if Issuer received a redemption notice; and
16. Subsidiary would require UK Parent to repay the Senior Loan in the event of an auction.

3. Annual Cash Flows (for the three taxable years at issue)

In year 1, UK Parent made total interest payments to Subsidiary on the Senior Loan of $g. Subsidiary paid Issuer $h of interest. Issuer, in turn, paid UK Sub1 $h of interest. No other payments were made in year 1.

In year 2, UK Parent made total interest payments on the Senior Loan to Subsidiary of $i. Subsidiary paid Issuer $j of interest and Issuer paid UK Sub1 $j of interest. Subsidiary distributed $k to Issuer, which distributed this amount to US Sub (and Transferee). It did not make any distributions to UK Sub1.

In year 3, UK Parent made total interest payments on the Senior Loan to Subsidiary of $i. Subsidiary paid Issuer $j of interest and Issuer paid UK Sub1 $j of interest. Subsidiary distributed $l to Issuer, which distributed this amount to Transferee. It did not make any distributions to UK Sub1.

In years 2 and 3, US Corp paid UK Sub2 $m and $n, respectively, in connection with the swap.

4. Tax Consequences (for the three taxable years at issue)

a. U.S. Tax Consequences

Taxpayers take the position that the Securities are equity interests in Issuer for U.S. tax purposes. Accordingly, for U.S. tax purposes, Taxpayers take the position that they

were partners in Issuer for the taxable years at issue. Taxpayers reported the following amounts attributable to the Securities:

Year 1 (US Sub)	
Distributive share of Issuer's taxable income:	$o
Distributive share of Issuer's U.K. taxes:	$p
Year 2 (US Sub)	
Distributive share of Issuer's taxable income:	$q
Distributive share of Issuer's U.K. taxes:	$aa
Year 2 (Transferee)	
Distributive share of Issuer's taxable income:	$bb
Distributive share of Issuer's U.K. taxes:	$cc
Year 3 (Transferee)	
Distributive share of Issuer's taxable income:	$dd
Distributive share of Issuer's U.K. taxes:	$ee

Taxpayers claimed foreign tax credits for Holders' distributive shares of Issuer's purported U.K. taxes.

b. U.K. Tax Consequences[3]

For U.K. tax purposes, UK Parent was entitled to interest expense deductions for the interest payments it made to Subsidiary on the Senior Loan.

Subsidiary was required to take into account the interest income it received from UK Parent. Subsidiary was entitled to interest expense deductions for the interest it paid to Issuer. The distributions made by Subsidiary to Issuer were not deductible in computing Subsidiary's taxable income. Subsidiary was subject to U.K. income tax on its taxable income.

Issuer was not taxable on the distributions it received from Subsidiary. The Securities are debt for U.K. tax purposes. Thus, Issuer was entitled to interest expense deductions for U.K. tax purposes for the cash distributions it made on the Securities. This resulted in losses for Issuer for U.K. tax purposes. Issuer surrendered these losses to UK Parent pursuant to the U.K. group relief rules (described below).

Under the U.K. tax system, each individual company is taxed on its own profits. Statutory rules relating to group relief, in general, allow one company's losses (and

[3]The TAM Submission and Appendix B thereto contain discussions of the relevant U.K. tax law, including the rules relating to group relief. This memorandum assumes that those discussions are an accurate description of U.K. tax law.

certain other attributes or "reliefs") to be set against another company's profits to reduce the tax liability of that other company. Group relief is available where the loss or "surrendering" company and the profitable or "claimant" company are both members of the same group relief group. Two companies are members of the same group if one is the 75 percent subsidiary of the other or both are 75 percent subsidiaries of a third company.

The system of group relief covers the relationship between a parent company and its subsidiaries (and between subsidiaries). Any member of a group relief group can make a claim in respect of the losses of any other member of the group. Appendix B to the TAM Submission states the following with respect to the group relief regime:

> There is no obligation for any group member to claim or surrender relief and there is no unilateral right for a group member to claim or surrender relief. An agreement to surrender and claim reliefs is effectively a contract entered into between the surrendering company and claimant company, or claimant companies. Therefore, group relief is elective between members and does not require that group relief be utilized to reduce the taxes of one member versus others.

Both Issuer and Subsidiary were part of UK Parent's group relief group for U.K. tax purposes. Therefore, U.K. law permitted Issuer and Subsidiary to agree that Issuer would surrender its losses to Subsidiary instead of UK Parent.

Under the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed on December 31, 1975, as amended by Protocols signed on August 26, 1976, March 31, 1977, and March 15, 1979 (the "1975 U.S.-U.K. Treaty"), no U.K. taxes were imposed on the Yield Payments to Holders. See Article 11(2) (Interest).

LAW AND ANALYSIS:

Issue #1

Payments to the U.K. in respect of Subsidiary's income are noncompulsory payments under Treas. Reg. §1.901-2(e)(5) to the extent those payments exceed the amount of U.K. tax that would have been due if Issuer had surrendered its losses to Subsidiary. The noncompulsory payments are not taxes paid for purposes of section 901 and Taxpayers are not eligible to claim credits under section 901 for such payments.

Section 901 permits a taxpayer to claim a credit for the amount of any income, war profits and excess profits taxes paid or accrued during the year to a foreign country.

Therefore, an amount paid to a foreign country must be an amount of tax paid to be eligible for credit under section 901.

Treas. Reg. §1.901-2(e) provides guidance in determining whether a payment to a foreign country is a payment of tax. Treas. Reg. §1.901-2(e)(5) provides that an amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax. For purposes of determining whether an amount paid exceeds the amount of liability under foreign law for tax, Treas. Reg. §1.901-2(e)(5) provides the following:

> An amount paid does not exceed the amount of such liability if the amount paid is determined by <u>the taxpayer</u> in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, <u>the taxpayer's</u> reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment). (Emphasis added.)

Treas. Reg. §1.901-2(e)(5) provides further that if foreign tax law includes options or elections whereby a taxpayer's liability may be shifted, in whole or part, to a different year, the taxpayer's use or failure to use such options or elections does not result in a noncompulsory payment. In addition, it provides that a taxpayer is not required to alter its form of doing business, its business conduct, or the form of any transaction in order to reduce its liability for tax under foreign law.

Treas. Reg. §1.901-2(e)(5) applies on a taxpayer-by-taxpayer basis, obligating each taxpayer to minimize its liability for foreign taxes over time. Therefore, the threshold question in the instant case is who is the "taxpayer" for purposes of Treas. Reg. §1.901-2(e)(5).

The rules for determining the taxpayer for foreign tax credit purposes are contained in Treas. Reg. §1.901-2(f). Treas. Reg. §1.901-2(f) provides the following:

> The person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax. . . . For purposes of [§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."

Accordingly, under Treas. Reg. §1.901-2(f), the taxpayer is the <u>person</u> on whom foreign law imposes legal liability for tax. Treas. Reg. §1.901-2(f) does not define the term "person." That term is defined in section 7701(a) as follows:

(a) When used in [this title], where not otherwise distinctly expressed or manifestly incompatible with the intent thereof-

(1) Person.- The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.

Treas. Reg. §§301.7701-2 and –3 provide guidance on the classification of certain entities for U.S. tax purposes. Paragraph (a) of Treas. Reg. §301.7701-2 provides that a disregarded entity's activities are treated in the same manner as a branch or division of the owner.

The payments at issue are purportedly U.K. taxes paid by Subsidiary with respect to its net income for U.K. tax purposes (i.e., its interest income on the Senior Loan less deductions for interest paid on its loan from Issuer). Because an election was made to treat Subsidiary as a disregarded entity, Subsidiary is treated as a branch or division of Issuer for U.S. tax purposes. See Treas. Reg. §301.7701-2(a). Accordingly, Issuer, purportedly a partnership for U.S. tax purposes, is the only "person" within the meaning of section 7701(a) and the Treasury regulations thereunder. Therefore, Issuer is the "person" on whom foreign law imposes legal liability for tax for purposes of Treas. Reg. §1.901-2(f) and the "taxpayer" obligated to minimize its liability for foreign taxes over time under Treas. Reg. §1.901-2(e)(5).

The next question is whether Issuer satisfied its obligation under Treas. Reg. §1.901-2(e)(5) to minimize its foreign tax obligations over time. That is, whether Issuer applied the substantive and procedural provisions of U.K. law in a manner that minimized its U.K. tax obligations over time. Issuer did not do so.

Both Issuer and Subsidiary were part of the UK Parent group relief group for U.K. tax purposes. Under the group relief provisions, any two members of a group can agree to invoke group relief. Relief is elective between members and is effectively a contract between the surrendering company and the claimant company. Thus, under the U.K. group relief rules, Issuer could have elected to surrender its losses to Subsidiary and Subsidiary could have elected to claim those losses. This would have reduced the amount of Subsidiary's taxable income for U.K. tax purposes and, thus, the amount of U.K. tax due with respect to such income. Issuer instead elected to surrender those losses to UK Parent. Therefore, Issuer failed to apply the substantive and procedural provisions of U.K. law in a manner that minimized its U.K. tax obligations.

The payments to the U.K. in respect of Subsidiary's income are noncompulsory payments under Treas. Reg. §1.901-2(e)(5) to the extent those payments exceed the amount of U.K. tax that would have been due if Issuer and Subsidiary had elected to surrender Issuer's losses to Subsidiary. Taxpayers are not eligible to claim credits

under section 901 for such payments because they are not payments of tax for purposes of section 901.

Taxpayers make several arguments in support of their position that the payments at issue should not be treated as noncompulsory amounts. We do not find Taxpayers' arguments persuasive.

First, Taxpayers argue that foreign law applies to determine the "taxpayer" under Treas. Reg. §1.901-2(f) and that, because U.K. law treats Subsidiary as a separate taxable corporation, Subsidiary, not Issuer, is the "taxpayer" under Treas. Reg. §1.901-2(f) and, thus, the taxpayer for purposes of Treas. Reg. §1.901-2(e)(5). Taxpayers conclude that the payments are compulsory since, under U.K. law, Subsidiary did not have the unilateral power to reduce its U.K. taxes by using Issuer's losses. Taxpayers misinterpret the role of foreign law under Treas. Reg. §1.901-2(f). Foreign law is relevant in determining which person, among several, is the person with "legal liability" and, thus, the taxpayer for foreign tax credit purposes. However, the meanings of the terms "legal liability" and "person" are determined under U.S. tax principles, not under foreign law. Cf. Biddle v. Commissioner, 302 U.S. 573, 578 (1938) (applying U.S. tax principles to determine whether a U.K. corporation or its shareholder was the payor of certain U.K. taxes for U.S. foreign tax credit purposes).

Further highlighting the flawed nature of Taxpayers' position is the fact that it is internally inconsistent. Taxpayers argue that they are entitled to claim credits under section 901 by virtue of their purported partnership interests in Issuer and purported distributive shares of U.K. taxes paid by Issuer. See section 702(a). Thus, Taxpayers' position is that Issuer is the "taxpayer" under Treas. Reg. §1.901-2(f) for purposes of claiming the credit. Notwithstanding this position, Taxpayers argue that Subsidiary, and not Issuer, is the person obligated to minimize its U.K. taxes under Treas. Reg. §1.901-2(e)(5). These positions are irreconcilable. The person obligated to minimize its foreign tax liability under Treas. Reg. §1.901-2(e)(5) is the person that Treas. Reg. §1.901-2(f) defines as the "taxpayer" for purposes of claiming the credit.

Taxpayers argue, in the alternative, that even if the term person is determined under U.S. tax principles, those principles include applicable treaties. Although Taxpayers acknowledge in their Supplemental Submission that the 1975 U.S.-U.K. Treaty applies to the tax years at issue, Taxpayers nonetheless attempt to rely on the 2001 U.S.-U.K. Treaty[4] and the Diplomatic Notes thereto as a contemporaneous "observation" that "the definition of 'person' includes disregarded entities." Even if the 2001 U.S.-U.K. Treaty

[4]Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed on July 24, 2001, as amended by the Protocol signed on July 19, 2002 (hereinafter the "2001 Treaty"). The 2001 Treaty entered into force on March 31, 2003, and has effect in respect of taxes other than taxes withheld at source from January 1, 2004.

were applicable, nothing therein supports Taxpayers' position. The Diplomatic Notes cited by Taxpayers provide, in relevant part, as follows:

> *With reference to Article 24 (Relief from Double Taxation):*
>
> it is understood that, under paragraph 4 or 8 of Article 1 (General Scope), the provisions of the Convention may permit the Contracting State of which a person is a resident (or, in the case of the United States, a citizen), to tax an item of income, profit or gain derived through another person (the entity) which is fiscally transparent under the laws of either Contracting State, and may permit the other Contracting State to tax a) the same person; b) the entity; or c) a third person with respect to that item. Under such circumstances, the tax paid or accrued by the entity shall be treated as if it were paid or accrued by the first-mentioned person for purposes of determining the relief from double taxation to be allowed by the State of which the first-mentioned person is a resident. . .

The quoted language clarifies that a U.S. owner of a U.K. hybrid entity (i.e., an entity that is a flow-through for U.S. tax purposes and a taxable entity, such as a corporation, for U.K. tax purposes) is allowed, subject to the limitations of U.S. law, to claim foreign tax credits for U.K. tax imposed on the hybrid entity. However, the Notes' use of the term "person" to refer to a hybrid entity does not govern the interpretation of that term for purposes of Treas. Reg. § 1.901-2(f)(1). Moreover, as noted above, Taxpayers' entitlement to credit for any taxes paid by Subsidiary depends on treating Issuer as the taxpayer, i.e., the person on whom foreign law imposes legal liability for the tax.

Next, Taxpayers argue that the structure of the transaction was necessary to meet the business objectives of the parties and that surrendering the loss to Subsidiary would have been a change in the form of the business transaction, which is not required by Treas. Reg. §1.901-2(e)(5). We are unpersuaded by Taxpayers' attempt to characterize the loss surrender as part of the form of the business transaction merely because the use of the loss was critical to the arrangement and agreed upon by the parties at the outset of the transaction.

Treas. Reg. §1.901-2(e)(5) required Issuer to apply the substantive and procedural provisions of U.K. tax law in a manner that minimized its U.K. tax liability, including by taking advantage of elections available under U.K. tax law. This is clear from the exception in the regulation for elections under foreign tax law that have the effect of shifting tax to different years. If tax elections under foreign law were outside the requirements of Treas. Reg. §1.901-2(e)(5) because tax elections constitute a change in the form of business, then no carve out would be necessary for options and elections that relate to timing. Here, Issuer (and its disregarded entity, Subsidiary) had the right under U.K. law to elect to surrender Issuer's loss to Subsidiary. The fact that Issuer voluntarily agreed in the transaction documents not to make this election because it was not in the interest of US Group and UK Parent to do so is irrelevant under Treas. Reg.

§1.901-2(e)(5).

Taxpayers cite two cases in support of their view that a taxpayer need not take advantage of available elections to minimize its foreign tax liability. Those cases are inapposite.

In Guardian Industries Corp. & Subs v. United States, 65 Fed. Cl. 50 (2005), *aff'd*, 2007 U.S. App. LEXIS 3927 (Fed. Cir. Feb. 23, 2007), the issue was whether the U.S. owner of a Luxembourg disregarded entity that was the parent of a Luxembourg consolidated group paid the entire Luxembourg consolidated tax or whether the U.S. owner paid only the portion of the Luxembourg consolidated tax attributable to the disregarded entity's income. The government's position, which the court rejected, was that the U.S. owner paid only the portion of the consolidated tax attributable to the disregarded entity's income because Treas. Reg. §1.901-2(f) required apportionment of the consolidated tax among all the members of the Luxembourg group. Under the government's theory, the consolidation election did not present a noncompulsory payment issue because the election did not have the effect of increasing the amount of Luxembourg taxes paid by the U.S. owner and the issue of whether the U.S. owner's payment of the Luxembourg consolidated tax was a noncompulsory amount was not presented.

Compaq Computer Corporation v. Commisioner, 113 T.C. 363 (1999), involved the payment by a U.K. corporation of U.K. advance corporation tax, which could be claimed as a credit against mainstream U.K. corporation tax. The principal issue in the case was whether the U.K. corporation paid tax within the meaning of Treas. Reg. §1.901-2(f) or whether, because the U.K. corporation elected to surrender the credit to its U.K. subsidiary, the U.K. corporation should be treated as receiving a refund and contributing it to the U.K. subsidiary, which used it to pay U.K. tax. The case did not involve a noncompulsory payment issue under Treas. Reg. §1.901-2(e)(5).

Taxpayers also rely on Rev. Rul. 80-4, 1980-1 C.B. 169. Rev. Rul. 80-4 involved a Netherlands Antilles corporation that made an election to be taxed under a certain provision of Netherlands Antilles law with respect to its U.S. source income. Rev. Rul. 65-16, 1965-1 C.B. 626, had previously concluded that such U.S. source income would be entitled to benefits (e.g., eligible for reduced U.S. withholding tax rates) under the United States-Netherlands Income Tax Convention as extended to the Netherlands Antilles. Rev. Rul 80-4 amplifies the earlier ruling and concludes that payments to the Netherlands Antilles on such income pursuant to the election are payments made pursuant to a legal liability for tax for foreign tax credit purposes "under the United States-Netherlands Income Tax Convention as extended to the Netherlands Antilles." This ruling, issued shortly after the noncompulsory payment regulations were proposed, clarified that, notwithstanding the proposed regulations, taxpayers would remain eligible to claim foreign tax credits for the Netherlands Antilles taxes paid on such income. Department of the Treasury News Release, "Effect of Proposed Foreign Tax Credit Regulations on Revenue Ruling 65-16" (June 27, 1979). The legal basis for the ruling

was the treaty. As such, the ruling is limited to taxes covered by the treaty and addressed in the ruling, and cannot be interpreted as establishing a general principle that taxpayers need not take advantage of elections available under foreign law to minimize their foreign tax liability. On the contrary, Rev. Rul. 80-4 provides additional evidence that the regulations require taxpayers to take advantage of such elections. If the regulations did not so require, then there would have been no need to issue a ruling on the treatment of the Netherlands Antilles taxes.

Finally, Taxpayers argue that the application of U.K. group relief is a mechanism for allocating U.K. taxes among a group of related U.K. companies, but does not result in any member paying more taxes than are due. In this regard, Taxpayers point out that regardless of whether Issuer's net losses reduced UK Parent's U.K. taxes or Subsidiary's U.K. taxes, the UK Parent group relief group, in the aggregate, would have paid the same amount of U.K. tax. In essence, Taxpayers' position is that the UK Parent group should be treated as a single taxpayer for purposes of Treas. Reg. §1.901-2(e)(5). This is contrary to the Treasury regulations. Treas. Reg. §1.901-2(f) treats as a separate taxpayer each person on whom foreign law imposes legal liability for tax and Treas. Reg. §1.901-2(e)(5) requires each such taxpayer to minimize its foreign tax obligations.

Taxpayers' Supplemental Submission to the TAM Submission makes several additional arguments. We do not find those additional arguments persuasive.

First, Taxpayers argue that Issuer and Subsidiary should be treated as separate persons for purposes of Treas. Reg. §1.901-2(e)(5) because the two companies were in substance separate persons. In this regard, Taxpayer states that there were two "ultimate" taxpayers (US Group/Transferee and UK Parent) and that, while Taxpayers were entitled to all of the cash flows from Subsidiary, UK Parent was at all times in control of Issuer's losses and was the sole beneficiary of those losses. The flaw in Taxpayers' argument is that neither the economic impact on the ultimate owners of a person nor the amount of control by the ultimate owners of a person is relevant for purposes of Treas. Reg. §1.901-2(e)(5). Pursuant to Treas. Reg. §1.901-2(f)(1), the sole question under Treas. Reg. §1.901-2(e)(5) is "who is the person legally liable for the tax under foreign law?" Here, that person is Issuer. [5]

Taxpayers also argue that Prop. Treas. Reg. §1.901-2(f) supports their position. That regulation is not currently effective and is not proposed to be effective for the tax years

[5] Even if the economic benefit from Issuer's losses and the control of Issuer were relevant considerations, this would not support Taxpayer's position. The creation of Issuer and Subsidiary as separate entities under U.K. law was intended to result in U.K. taxes that Taxpayers could claim as credits. The creation of losses at the Issuer level under U.K. law and the surrender of those losses to the UK Parent group was an element of this scheme, which benefited both parties. Thus, the parties mutually agreed at the outset of the transaction that the losses would not be used by Subsidiary. (See the description above of Issuer's covenants in the Instrument.)

at issue. In any event, rather than support Taxpayers' position, Prop. Treas. Reg. §1.901-2(f)(3)(ii) would explicitly confirm that the "taxpayer" for foreign tax credit purposes is the owner of the disregarded entity (Issuer), not the disregarded entity (Subsidiary). Although special rules for foreign consolidated groups treat a disregarded entity as a separate person for the limited purpose of allocating foreign taxes among the members of a foreign consolidated group, those special rules would not apply to group relief regimes such as the U.K. regime (see Prop. Treas. Reg. §1.901-2(f)(2)(ii)(A)) and, in any event, would not override the general rule that the "taxpayer" is the owner of the disregarded entity (i.e., the owner of a disregarded entity would be considered to pay foreign taxes allocated to the disregarded entity under the foreign consolidated group rule).[6]

Finally, Taxpayers attempt to make much of the fact that the U.S. tax results might be different if Subsidiary were itself a partnership for U.S. tax purposes instead of a disregarded entity. However, the issue of whether the payments made by Subsidiary would be compulsory amounts under Treas. Reg. §1.901-2(e)(5) if Subsidiary were a partnership for U.S. tax purposes is not relevant. A taxpayer has the option to choose its form of doing business, including whether it operates in a foreign jurisdiction through a corporation, partnership or branch. It is uncontroversial, however, that once a taxpayer chooses its form of doing business, the taxpayer must live with the U.S. tax consequences of its choice. Therefore, while Taxpayers could have chosen a different form of doing business with respect to which the requirements of Treas. Reg. §1.901-2(e)(5) may have been satisfied, the fact is Taxpayers did not do so.

Issue #2

A. The Securities are debt of UK Sub1

The Securities are debt instruments for U.S. tax purposes. Alternatively, the Securities are more like debt than equity for U.S. tax purposes. Therefore, Taxpayers are not entitled to foreign tax credits for U.K. taxes paid with respect to Subsidiary's income.

A taxpayer that is a partner in a partnership is eligible, subject to applicable limitations, to claim a credit under section 901 for its distributive share of foreign income taxes paid or accrued by a partnership. See section 702(a). Accordingly, notwithstanding

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[6] In consolidated return regimes where a single tax is imposed on the combined income of several companies, each company's share of the combined income must be determined in order to allocate the single tax among the companies. The proposed regulations contain a loss allocation rule for foreign consolidated groups that would apply in determining each member's share of that combined base. Taxpayers infer from the fact that there are no such loss allocation rules under Prop. Treas. Reg. §1.901-2(f) for group relief groups, there is an intent to provide "more flexible rules" for group relief groups and to permit taxpayers in group relief situations to elect the company to which losses are surrendered. There is no basis to draw such a conclusion. On the contrary, the more reasonable explanation is that there is no need for a loss allocation rule in a group relief situation because companies are taxed on a separate basis under group relief regimes.

Taxpayers' argument that Subsidiary is the "taxpayer" for purposes of Treas. Reg. §1.901-2(e)(5), Taxpayers nonetheless seek to claim credits pursuant to sections 702(a) and 901 for the payments made to the U.K. based on their position that Issuer is the "taxpayer" for purposes of Treas. Reg. §1.901-2(f)(1) and that Taxpayers are entitled to foreign tax credits for U.K. taxes paid by Issuer because the Securities are partnership interests in Issuer for U.S. tax purposes.

However, the Securities are in the nature of debt, not equity, for U.S. tax purposes. For U.S. tax purposes, Issuer is a branch or division of UK Sub1, and Holders are considered to hold debt of UK Sub1 and to receive interest from UK Sub1 in the amount of the distributions on the Securities. Therefore, Holders are not partners in Issuer and cannot claim credits pursuant to sections 702(a) and 901 for any U.K. taxes paid by Issuer.

Increasingly, courts have had occasion to determine whether arrangements between parties are properly characterized as partnership interests or as debt. In Comm'r v. Culbertson, 337 U.S. 733 (1949), the Supreme Court ruled that a partnership exists when, "considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." Id. at 742. The Second Circuit in TIFD III-E, Inc. v. Commissioner (Castle Harbour), 459 F. 3d 220 (2d Cir. 2006), rev'g 342 F. Supp. 2d 94 (D. Conn. 2004), recently restated these principles and found that the issue ultimately turned on whether the purported partner had a meaningful stake in the success or failure of the business, i.e., "whether 'the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business.'" 459 F. 3d at 233 (citing Gilbert v. Commissioner, 248 F.2d 399, 406 (2d Cir. 1957)). Such a determination must be based on an assessment of the practical realities and not upon the fictions of the partnership agreement. Id. at 234. The Court also considered the following factors (none of which is conclusive) to determine whether a partnership interest existed: whether the parties share in the upside potential, if any, of the arrangement; whether the issuer gave an unconditional promise to pay a sum certain; whether the transferor had a right to compel payment of principal and interest; whether the transferor's interest was subordinated to general creditors' interests; and whether the transferor had management rights, as well as other factors. See also ASA Investerings v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000), aff'g 76 T.C.M. (CCH) 325 (1998); Estate of Kahn v. Commissioner, 499 F.2d 1186, 1189 (2d Cir. 1974) (identifying factors a court might consider); Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964) (same). Viewed in their entirety, the relevant factors compel the conclusion that the Securities are debt for U.S. tax purposes or, in any event, are more like debt than equity under U.S. tax principles.

a. Risk of loss or share in upside potential

This factor focuses on whether the arrangement exposes the investor's capital to entrepreneurial risk. In this case, the Instrument negated any possibility of meaningful entrepreneurial risk. Instead, Holders were guaranteed repayment of a sum certain. The Instrument gave Holders a secure guaranty of the reimbursement of their investment as well as a guaranteed rate of return. The Yield Payments provided that guaranteed rate of return. Issuer was required to remit the Yield Payments quarterly, on the same day UK Parent paid Subsidiary. The amounts were fixed for the first year, increasing by 20 basis points in years two through five. The redemption, auction, and liquidation provisions guaranteed Holders a return of their principal. Those provisions ensured that Holders would never exit the arrangement, whether via redemption or auction, without full reimbursement of their principal and any accrued, but unpaid, Yield Payments. (See the discussion in part b below under "Holders' rights to compel payment.")

The Yield Payments were fixed and certain. They were not contingent upon a declaration by the Board of Directors. Instead, the Instrument fixed these amounts as due and payable and the Articles of Association of Issuer triggered a liquidation of Issuer if Issuer failed to make Yield Payments for four consecutive quarters. The Instrument sought to create the illusion of contingencies by conditioning the Yield Payments on solvency, minimum net worth, and earnings and profits. Parse the definitions of these terms, however, and the contingencies prove non-existent.

Key to parsing these conditions is the definition of "liabilities." Issuer covenanted not to incur any liabilities other than Issuer Permitted Liabilities. The Instrument defined Issuer Permitted Liabilities in such a way as to limit these liabilities to $b, which was serviced by interest payments from Subsidiary, and $f, a de minimus amount in light of the over-collateralization and the spread between the interest rate payable to Subsidiary on the Senior Loan and the rate payable to Holders on the Securities. The Instrument defined liabilities of Issuer to exclude any claims that UK Sub1 may have had by virtue of its ownership of the $a ordinary shares of Issuer. In its analysis of the risk of the transaction, US Group cited the definition of Issuer Permitted Liabilities as one factor that helped ensure that income from the Senior Loan would support the Yield Payments. Credit Approval Report.

The solvency condition was two-pronged. The Instrument defined solvency as Issuer being able to pay liabilities as they came due and having book assets exceeding book liabilities (excluding the Securities for this purpose). The definitions of Issuer Permitted Assets and Issuer Permitted Liabilities guaranteed that Issuer would always be able to pay its liabilities as they came due because the effect of the definitions was to limit the liabilities to $f, a de minimus amount, and $b, which was serviced by interest payments from Subsidiary. The second prong required Issuer's book assets to exceed book liabilities (excluding the Securities for this purpose). This prong would always be

satisfied. Issuer's book assets included its equity interest in Subsidiary of $d and its loan receivable of $b, which would always exceed its book liabilities of $f and $b.

The minimum-net-worth condition required that the book value of Issuer's assets exceed 101% of the book value of its liabilities (including the value of the Securities). The book value of Issuer's assets was always $e at least. The book value of Issuer's liabilities for these purposes would always be the sum of $c, $b, and its share of $f. Temporary items, such as receivables and payables, would net, largely. The Instrument fixed the results for this test because $e would exceed the sum of liabilities by an amount approximately equal to UK Sub1's capital contribution of $a, an amount more than adequate to satisfy the 101% test.

The Instrument also guaranteed that there would be sufficient earnings and profits (as determined for U.S. tax purposes) through the combination of the interest rate spread, the over-collateralization and the limitations on the liabilities of Issuer and Subsidiary. Substantially all of the income of Issuer and Subsidiary consisted of interest on the Senior Loan. UK Parent paid to Subsidiary a fixed s% rate of interest on principal of $e, subject to purported U.K. tax at a rate of 30%. Issuer's and Subsidiary's items of expense were limited to the purported U.K. tax payments, interest on the $b loan from UK Co1 to Issuer and other expenses limited to expenses on a total principal amount of $f. The only significant item of expense for Issuer and Subsidiary was the purported U.K. tax. The Yield Payments to Holders on $c principal amount of Securities, were t% in the first year and u% in years two through five. The spread between the rates on the Securities and the rate on the Senior Loan were 1.2 percentage points in year one and 1 percentage point in years two through five, favoring Issuer. Moreover, the Yield Payments on the Securities were a function of principal $c, which was less than $e. A combination of over-collateralization, at 1.22:1,[7] and interest rate spread guaranteed that Issuer would always have sufficient earnings and profits for Yield Payments, even taking into account the purported U.K. tax payments made with respect to Subsidiary's interest on the Senior Loan. Therefore, no contingencies existed with respect to the Yield Payments.

In addition, the Instrument made it impossible for Issuer and Subsidiary to do anything other than funnel money to UK Parent. If Issuer and/or Subsidiary had participated in any business activity, this would have triggered a liquidation of Issuer. Furthermore, to the extent Subsidiary accumulated any cash, the Instrument mandated that Subsidiary invest these residual amounts only in high-grade, dollar-denominated debt securities, cash equivalents or, under certain conditions, additional loans to UK Parent (or other members of its group). See, e.g., ASA Investerings, 76 T.C.M. at 336 (risk minimized by requiring partnership to invest in AAA-rated, diversified, high-grade assets). Thus, the parties ensured that they eliminated any investment risk in holding the Issuer Permitted Assets and Subsidiary Permitted Assets. These provisions make clear that

[7] Recall that the Transaction Approval Document indicated that the over-collateralization obviated the need for UK Parent's guarantee.

the purpose of Issuer and Subsidiary was simply to funnel money from US Group to UK Parent.

b. Holders' rights to compel payment

Under the Instrument, Holders had the right to compel payment and recoup the principal and any accrued, but unpaid, Yield Payments. This right supports the conclusion that the transaction was a loan and not equity. See, e.g., Castle Harbour, 459 F.3d at 237-238; Estate of Mixon v. United States, 464 F.2d 394, 405 (5th Cir. 1972); Notice 94-47, 1994-1 C.B. 357. US Group considered its right to compel payment in its analysis of the deal, including UK Parent's credit risk. US Group recognized that its right to compel payment ensured that US Sub (and, later, Transferee) could "engineer its exit" from the transaction with its investment and return intact, as discussed more fully below.

The auction procedures were structured such that the Securities were callable by Holders after one year and would effectively mature at the end of five years if not called prior to that time, notwithstanding that the parties labeled the Securities as "perpetual." See Zilkha v. Commissioner, 52 T.C. 607, 617 (1969) (concluding that a security may be treated as having a fixed maturity even if lacking one in form based on facts assuring redemption). First, the Instrument did not set a maximum bid for the yield on the Securities. Compare Rev. Rul. 90-27, 1990-1 C.B. 50. Thus, Holders could bid a sufficiently high rate to force an exit from the transaction because Holders had "absolute discretion" to bid any rate. If the bid was sufficiently high, Issuer would be economically compelled to invoke its own "escape clause" and redeem the Securities on the basis that the bid exceeded a reasonable rate or find a new purchaser for the Securities.[8] In either case, Holders were entitled to an amount equal to the Redemption Price. In addition, Holders could control the timing of auctions, to a great extent, because at any time after Date 5, one year after the beginning of the transaction, Holders could demand an auction under the Instrument for any – or no – reason. Compare Rev. Rul. 90-27 (auction times prearranged to occur every 49 days and participants had no right to control the timing of an auction). Thus, the auction provisions gave Holders the right to compel full recovery of their investment and return and to time an exit from the transaction.

US Group relied upon its rights to control the timing of an auction and to bid a high rate in its analysis of the Securities, concluding that its "exposure" to UK Parent would be "short-term." In the Credit Approval Report under a discussion captioned "Exit Routes/Redemption," US Corp stated the following:

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[8]The Instrument imposed a nominal contingency on any redemption by conditioning redemptions upon Issuer's having sufficient adjusted net capital. However, the definitions of "adjusted net capital" and Issuer Permitted Liabilities ensured that Issuer would always have sufficient capital to permit redemption of the Securities.

> Twelve months after the issuance of the Securities, [US Corp] has an unfettered right to request [UK Parent] to hold an auction of the Securities. [US Corp] is obliged to bid for the whole of the Securities at the rate it deems reasonable in its sole discretion. If [Issuer] is not satisfied with the outcome of the bids, it can procure that the Senior Loan (which is repayable on 5 business days notice) be repaid in order to permit the redemption of the Securities at par value plus any accrued or deferred yield payments. If [US Corp] decides that it no longer wishes to invest in the Securities, and thus bids a sufficiently high rate in any auction, then the issuer of the Securities should have an economic compulsion to redeem or transfer the Securities to other bidders. Therefore, we take the view that the exposure to the Securities can be considered as short-term. Five years after the issuance of the Securities, an auction will be held to reset the rate to either fixed or floating. If the bids received by [Issuer] are too high, [Issuer] can give a notice of redemption of the Securities at par plus any accrued yield payment.

Moreover, the transaction documents indicate that the parties intended to redeem the Securities upon the calling of an auction and not even follow the auction procedures. Section 7(2)(s)(iv) of the Instrument requires Subsidiary to call the Senior Loan upon the calling of an auction by Holders. The calling of the Senior Loan is a Liquidation Event for Issuer under the Instrument, unless Subsidiary and UK Parent enter into a replacement loan facility within ten days of the call. Under section 7(1)(u) of the Instrument, Issuer must use the proceeds from the Senior Loan to redeem the Securities.

Other factors show that the parties intended the transaction to terminate no later than five years after issuance of the Securities. The Instrument fixed Yield Payments through year 5, the year in which the deal in fact unwound, and set no Yield Payments thereafter. The contemporaneous interest-rate swap between US Corp and UK Sub2 had a five-year term. The interest rate that UK Parent paid Subsidiary was the five-year fixed equivalent US$LIBOR. [9]

Furthermore, the liquidation provisions secured Holders' authority to compel redemption of the Securities upon the occurrence of certain events. The definition of Liquidation Events was quite broad and, from the debtor's perspective, stringent. By cross-reference to events of default defined in the Senior Loan Document, a single failure by UK Parent to remit one interest payment timely and in the right currency was a basis for liquidation of Issuer. In addition, Issuer's failure to make Yield Payments in four

[9] Practitioners have observed that, to survive recharacterization, an interest cast as preferred stock should have a term exceeding the five-year "minimum." See Robert H. Scarborough, *Partnerships as an Alternative to Secured Loans*, 58 Tax Lawyer 509, 527 (Winter 2005), and Rev. Rul. 78-142, 1978-1 C.B. 112. Arguably, this rule-of-thumb did not escape the Promoter of this transaction.

consecutive quarters triggered liquidation. By contrast, true equity holders have no right to force the liquidation of the company for failure to pay dividends.

c. Subordination to the interest of general creditors

Another factor listed in Notice 94-47 is "whether the rights of the holders of the instruments are subordinate to the rights of general creditors." Issuer liabilities were the only claims to which the Securities were subordinate. The Instrument's several provisions regarding liabilities ensured, however, that the subordination to Issuer liabilities was strictly illusory. First, Issuer covenanted that it would incur no liabilities other than Issuer Permitted Liabilities, and breach of a covenant triggered an automatic liquidation of Issuer. Issuer Permitted Liabilities included only: (1) liabilities to Subsidiary; (2) liabilities under the $b loan from UK Sub1; (3) liabilities to UK Parent or affiliates thereof; and (4) any liabilities incurred in respect of taxation, auditors' and legal fees, or any other routine expenses. Issuer had no liabilities to the Subsidiary and the definition of Subsidiary Permitted Assets effectively limited any such liabilities to loans from Subsidiary in the event Issuer lacked sufficient funds to make payments in respect of the Securities. In regard to the loan from UK Sub1, Issuer's liability was a wash, as Subsidiary serviced that loan with Issuer in the position of financial intermediary. In any event, the loan from UK Sub1 never exceeded $b, a modest amount given the extent of over-collateralization that the parties built into the arrangement. The Instrument's reference to UK Parent liabilities suggested the potential for Issuer indebtedness to UK Parent, but none arose. Moreover, the Instrument capped Issuer's liabilities to UK Parent and its affiliates, plus accounting, legal and routine trade debts for both Subsidiary and Issuer, at $f. This amount was so small, and the over-collateralization so generous, that Issuer liabilities would never jeopardize Holders' right to payment.

d. Management rights

Lack of participation in management suggests that the Securities were more like debt than equity. See, e.g., Castle Harbour, 459 F.3d at 238; Estate of Mixon, 464 F.2d at 406. The Instrument denied Holders voting rights as a general matter, although US Corp contributed r% of Issuer's capital. See Castle Harbor, 459 F.3d at 238 (court cited Dutch banks' 18% contribution to capital but no right to participate in management). In addition, Holders had no right to participate in the appointment or dismissal of any member of the Board of Directors of Issuer; that right belonged to UK Sub1 under Issuer's Articles of Association. Articles of Association, clause 17.

What Holders did have was the right to vote at meetings of the Securityholders. However, the right to vote at that meeting did not translate into the right to manage Issuer. Rather, the right to vote at meetings appeared to preserve Holders' right to

prevent Issuer from modifying the Instrument as well as protecting Holders' right to hold the Securities, and not substitute interests.[10] No such meeting occurred.

In other cases, management rights have included the right to control, or have a say in, the disposition of inside assets. See, e.g., Hunt v. Commissioner, 59 T.C.M. (CCH) 635 (1990). The only inside assets that Issuer, and more accurately Subsidiary, may have held were the Subsidiary Permitted Assets. Holders had no control over the disposition or management of these assets. Indeed, upon a redemption of the Securities, the holder of the Securities was entitled only to its Redemption Price, not to a share of the inside assets.

e. Use of US Sub's contribution

Courts may consider the ultimate uses of contributions in determining whether an arrangement is a loan or equity. See Castle Harbour, 459 F.3d 220, 240; Hambuechen v. Commissioner, 43 T.C. 90, 99 (1964). In this case, Issuer and Subsidiary on-lent US Sub's contribution to UK Parent, which used the Senior Loan proceeds, not to finance an entrepreneurial venture, but to satisfy other outstanding debts. Holders provided cheap financing, made cost-effective for Holders by structuring the transaction to generate foreign tax credits for Holders.

f. Holders' evaluation of the transaction as a loan

In ASA Investerings, 76 T.C.M. (CCH) at 336, the Tax Court examined the way the Dutch bank processed and analyzed the deal, i.e., as a loan. In this case, US Group did the same. It analyzed UK Parent's credit risk and assigned what appeared to be a standardized risk rating, the highest rating available, based solely on UK Parent's fundamentals. The Credit Approval Report describes UK Parent and its subsidiaries as a "borrower" and characterizes the "risk category" of the deal as one of "Loan and Loan Equivalents." The Credit Approval Report emphasized the provision of cheap financing to UK Parent as an important strategy to maximize US Corp's exposure within the ranks of UK Parent's senior management in order to enhance and expand their lending relationships with UK Parent and its subsidiaries. Similarly, one of the ultimate uses of the contributions in ASA Investerings was to enhance the Dutch bank's already-existing relationship with Allied-Signal. Id. at 327.

g. Emphasis on U.K. tax law indicative of parties' intent

[10] At these meetings, Holders could vote, also, on certain matters to occur via "Extraordinary Resolution." An "Extraordinary Resolution" simply was a resolution proposed at a meeting of Securityholders and passed by three-quarters vote. Holders could vote on persons to execute an Extraordinary Resolution and authorize actions which the Instrument required to occur under Extraordinary Resolution. However, the Instrument was silent, otherwise, on what actions may have required an Extraordinary Resolution.

The parties would not have engaged in this particular transaction but for the allocation to US Sub (and, later, Transferee) of purported U.K. taxes and Holders' supposed eligibility to claim credits for those taxes. Several provisions in the Instrument underscore that the U.K. tax rate and the availability of foreign tax credits were critical to the arrangement. One of the auction events was the movement of the U.K. tax rate outside of a defined band. Subject to variation, the Yield Payments bore an inverse relationship to changes in the U.K. tax rate. If Issuer or Subsidiary breached a covenant and such breach had a "material adverse effect" on the "annual US tax credit position" of Holders with respect to the U.K. taxes the parties anticipated Subsidiary would pay, the Instrument entitled Holders to liquidated damages determined according to a formula in the Instrument. Instrument, Art. 8. Arguably, even the Instrument itself reveals that the deal between Issuer and Holders was, to a significant extent, about allocations of the purported U.K. taxes to Holders.

In summary, each of these factors supports the characterization of the Securities as debt obligations of UK Sub1, the sole equity owner of Issuer. Because Holders are creditors of UK Sub1 rather than equity owners in Issuer, they are not entitled to foreign tax credits for U.K. taxes paid in respect of Subsidiary's income.

B. The Securities are debt of UK Parent

Alternatively, Issuer and Subsidiary are mere conduits and the substance of the Transaction is a loan from US Sub (and, subsequently, Transferee) to UK Parent. Therefore, for U.S. tax purposes, US Sub and Transferee are considered to receive interest income from UK Parent in the amount of the distributions they received from Issuer. Taxpayers are not entitled to claim credits pursuant to sections 702(a) and 901 for the U.K. taxes imposed in respect of Subsidiary's income.

Issuer and Subsidiary are mere conduits. Thus, US Sub and Transferee are creditors and UK Parent is the debtor. Issuer and Subsidiary funneled 100% of their capital to UK Parent, as the Instrument bound them to do. Issuer and Subsidiary were not merely thinly capitalized; they had zero capitalization, effectively, because these contributions were not real risk capital (see arguments above regarding guaranteed recovery of principal and interest). Neither Issuer nor Subsidiary carried on a trade or business. Indeed, the Instrument barred them from so doing. Issuer and Subsidiary were mere shells, formed solely to accommodate a transaction marketed by Promoter. Accordingly, when US Group analyzed the transaction, US Group looked to the creditworthiness and risk of UK Parent. US Group accorded this transaction its most favorable risk rating on the basis of UK Parent's fundamentals alone. In fact, in its credit analysis, US Group stated, explicitly, that the Yield Payments and recovery of investment depended solely on UK Parent's ability to service the loan.

As US Group disregarded the conduit entities, so did the Tax Court in ASA Investerings v. Commissioner, 76 T.C.M. (CCH) 325 (1998), aff'd, 201 F.3d 505 (D.C. Cir. 2000).

The shelter involved a capital loss generator, promoted by Merrill Lynch, that required the taxpayer to form a partnership with a Dutch bank. The plan required the Dutch bank to form corporations that would hold the nominal partnership interests directly. The corporations were thinly capitalized shells established for the sole purpose of participating in the arrangement. Id. at 333. The Tax Court disregarded the partnership, as well as the corporations, as mere conduits, and recharacterized the arrangement between the taxpayer and the Dutch bank as a loan. The Tax Court reached this conclusion on the basis that, inter alia, the Dutch bank evaluated and approved the transaction, not just as a loan, but as a loan to the taxpayer. The Dutch bank reviewed the financial statements of the taxpayer, not of the conduit corporations, in seeking to insulate itself from credit risk. Id. at 336. US Group did the same thing in this case, looking through Issuer and Subsidiary to the viability of UK Parent.

Del Commercial Properties v. Commissioner, 251 F.3d 210 (D.C. Cir. 2001), is another case in which a court disregarded conduit entities, in large part because the commercial bank providing the loan ignored the nominal debtor and dealt substantively with the actual debtor. In Del Commercial, the taxpayer sought to avoid the withholding requirements under section 1441 by routing the loan through a related foreign financing company. The first-tier subsidiary of a Canadian parent corporation was the nominal debtor on a loan from the Royal Bank of Canada (hereinafter "RBC"). The taxpayer routed the proceeds, however, to the ultimate debtor, the U.S. subsidiary, via a related Netherlands Antilles corporation. By routing the interest payments through the Netherlands Antilles corporation, the structure allowed the U.S. subsidiary to pay interest to RBC without withholding U.S. tax that would have been due under the U.S.-Canada tax treaty. The U.S. subsidiary guaranteed the repayment of a portion of the amounts owed to RBC, and the U.S. subsidiary authorized RBC to mortgage its real property in the U.S. The U.S. subsidiary agreed to provide RBC with "annual financial statements, to insure its real property, to assign the insurance policies to RBC, to defer paying dividends to shareholders, and to use the proceeds from any sales of real property to make payments on the…loan." Id. at 212. On these facts, among others, the appellate court upheld the Tax Court's ruling that, as an initial matter, the intermediary entities were mere conduits in the loan that in reality was between the U.S. subsidiary and RBC and, ultimately, that the arrangement was a sham to avoid U.S. taxes. With real money at risk, the bank, through its course of dealing, revealed who the debtor really was. Similarly, US Group's course of dealing reveals who the real debtor is: US Corp (and, later, Transferee) made a loan to UK Parent, with Issuer and Subsidiary acting as mere conduits.

Del Commercial warrants a discussion of NIPSCO v. Commissioner, 115 F.3d 506 (7th Cir. 1997), aff'g 105 T.C. 341 (1995), and, in particular, the Tax Court opinion in that case. Like Del Commercial, NIPSCO is a case in which the Government asserted that the taxpayer routed lending through a foreign financing subsidiary in order to avoid withholding under section 1441. Unlike Del Commercial, the courts did not disregard the foreign financing subsidiary. In NIPSCO, the U.S. taxpayer sought to borrow not

from a commercial bank, but in the Eurobond market. The U.S. taxpayer capitalized the foreign financing subsidiary with $28,000,000, or approximately 40% of the amount of its Eurobond indebtedness. Moreover, the indenture agreement with Eurobond holders required the finance subsidiary to maintain a net worth at least equal to 40% of indebtedness. To understand the Eurobond market, the Tax Court looked to the legislative history of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 652, which stated:

> Because the Eurobond market is generally comprised of bonds not subject to withholding tax by the country of source, an issuer may not be able to compete easily for funds in the Eurobond market solely on the basis of price if its interest payments are subject to a substantial tax. U.S. corporations currently issue bonds in the Eurobond market free of U.S. withholding tax through the use of international finance subsidiaries, almost all of which are incorporated in the Netherlands Antilles.

NIPSCO, 105 T.C. at 352.

Accordingly, the Tax Court found that Eurobond holders would not have lent money to the U.S. taxpayer directly, because the Eurobond holders did not want tax withheld from their interest payments. In order to borrow in the Eurobond market, therefore, the U.S. taxpayer formed its foreign finance subsidiary "to comply with the requirements of prospective creditors, a business purpose of the kind recognized by the Supreme Court in *Moline Properties* [citation omitted]." Id. at 355. For the Tax Court, this finding was the threshold issue, a point arguably overlooked at the appellate level. The Court found, also, that Eurobond holders "were willing to enforce their rights over both" the foreign finance subsidiary and its U.S. parent. Id. at 354. The holders could enforce their rights against the finance subsidiary because of its $28,000,000 capitalization and its pledge that it would maintain net worth at no less than 40% of indebtedness.

NIPSCO is different from the case at hand. In NIPSCO, the taxpayer formed a foreign financing subsidiary as a prerequisite to borrowing in the Eurobond market. The taxpayer could not have accessed the Eurobond market otherwise. By contrast, US Group and UK Parent did not form Issuer and Subsidiary to conform to the market practices of UK Parent. Instead, Promoter pitched the transaction as a mechanism for the parties to exploit inconsistencies between U.S. and U.K. law and share the benefit of the foreign tax credit.

In NIPSCO, the taxpayer capitalized the foreign financing subsidiary with $28,000,000. Under the terms of the bond indentures, the financing subsidiary pledged this amount as its minimum net worth going forward. Simply put, the finance subsidiary was not a mere shell. On these facts, the Tax Court was able to find that the Eurobond holders could proceed, realistically, against either the financing subsidiary or its U.S. parent. By

contrast, Issuer and Subsidiary had no real capital; they funneled all of it to UK Parent in the Senior Loan, as the Instrument required. Otherwise, Issuer and Subsidiary were mere shells. If Subsidiary accumulated any of the float on the loan from UK Parent (i.e., any profit from Subsidiary's Permitted Assets), the Instrument made no provision for US Group or Transferee to assert any claim against it. Rather, US Group correctly identified UK Parent as the only party against whom it would have any meaningful claim.

Accordingly, the Securities constituted debt of UK Parent.

Issue #3

The anti-abuse rule of Treas. Reg. §1.701-2(a) applies to prevent Taxpayers from claiming foreign tax credits.

Treas. Reg. §1.701-2(a) provides that subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. It provides that the following requirements are implicit in the intent of subchapter K:

1) The partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose.

2) The form of each partnership transaction must be respected under substance over form principles.

3) The tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic arrangement and clearly reflect the partner's income (subject to certain exceptions).

Treas. Reg. §1.701-2(b) provides, in part, that the provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K. Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast a transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K--

1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;

2) One or more of the purported partners should not be treated as a partner;

3) The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or partner's income;

4) The partnership's items of income, gain, loss, deduction, or credit should be reallocated; or

5) The claimed tax treatment should otherwise be adjusted or modified.

Treas. Reg. §1.701-2(c) provides, in part, that whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. Additionally, Treas. Reg. §1.701-2(c) lists factors that may be considered in making the determination:

1) The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;

2) The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;

3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

4) Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

5) Partnership items are allocated in compliance with the literal language of Treas. Reg. §§1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);

6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

The weight given to any factor depends on all the facts and circumstances, and the presence or absence of any factor does not create a presumption that the partnership was, or was not, used in a manner inconsistent with the intent of subchapter K.

Holders and UK Sub1, a subsidiary of UK Parent, are purported partners in Issuer, a partnership for U.S. federal income tax purposes. The facts show that US Sub and UK Sub1 contributed $c and $a, respectively, to Issuer. Subsidiary was formed by Issuer and elected to be treated as a disregarded entity for U.S. federal income tax purposes. Issuer conducted no business activity, but simply contributed the majority (and lent a small portion) of its capital to Subsidiary. Subsidiary, in turn, lent the entire sum to UK Parent. Taxpayers claim in their Supplemental Submission that the purpose for entering into the structured arrangement was two-fold: one, to reduce its credit risk; and two, to increase pre-tax profit. Taxpayers claim that they were only concerned with pre-tax profit (their distributive shares of Issuer's interest income) and not after-tax profit because in all events they would be required to pay a combined foreign and domestic tax rate of 35%. Thus, by increasing pre-tax profit, Taxpayers were able to increase their after-tax returns. In view of the facts, however, these stated business purposes are not credible.

First, Taxpayer's contention that the structure of the transaction reduced its credit risk is undermined by its own documents. US Corp's Credit Approval Report indicates that the transaction as structured had the same risk rating as a direct loan to UK Parent. Therefore, the transaction structure and the over-collateralization did nothing to reduce US Sub's credit risk.

Second, Taxpayers' claimed enhanced return is illusory. This arrangement was intentionally structured to shift UK Parent's U.K. taxes to Subsidiary in order to generate foreign tax credits for Taxpayers. The parties agreed to share the cost of the U.K. taxes shifted to Subsidiary. The portion of the interest income on the Senior Loan that was attributable to the contributions made by UK Sub1 to Issuer (and disproportionately allocated to Taxpayers) was not distributed in cash to Taxpayers, but was used to pay Subsidiary's U.K. tax. Thus, while Taxpayers claim a foreign tax credit for the full amount of the payments to the U.K., UK Parent effectively bore the expense of a significant portion of such payments. Taxpayer's benefit from structuring the transaction as the parties did was not to generate an enhanced return, but to generate foreign tax credits for Taxpayers.[11]

Accordingly, we conclude that Taxpayers' stated business purposes are insubstantial when compared to the significant reduction of their U.S. tax liabilities. Two factors set forth in Treas. Reg. §1.701-2 lead us to this result.

First, the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership assets and conducted the partnership's activities directly. For example, if Holders had lent the $c directly to UK Parent at an interest rate of s%,[12] Holders would have earned $ff of interest income for the period at issue annually, which would not have been subject to U.K. tax. See 1975 U.S.-U.K. Treaty, Article 11. The U.S. federal income tax attributable to such amount is $gg ($ff x 35%). The Securities generated approximately $hh of taxable income annually and approximately $ii of foreign tax credits.[13] The U.S. federal income tax attributable to $hh is $jj ($hh x 35%). Thus, after taking into account the foreign tax credits, the U.S. federal income tax attributable to the transaction is approximately $kk. Since UK Parent and UK Sub1 are foreign entities, we assume they have no U.S. tax consequences in either a transaction involving a direct loan from Holders to UK Parent or in the transaction as structured. Therefore, the transaction as planned violated the intent of subchapter K because the present value of the partners' aggregate federal tax liability is

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[11] Taxpayers' Credit Approval Report also emphasizes its desire to provide cheap financing to UK Parent in order to enhance and expand its lending relationship with UK Parent and its subsidiaries. We agree that this transaction was designed to provide UK Parent with lower finance costs. However, this goal was accomplished by shifting UK Parent's U.K. taxes to Subsidiary and, thereby, generating foreign tax credits for Taxpayers. UK Parent obtained a below-market rate of financing (after taking into account its interest expense and the U.K. losses surrendered to it) because Taxpayers shared the benefit of the foreign tax credit with UK Parent through the amount of the Yield Payments on the Securities. Providing cheap financing in order to obtain the business of a foreign borrower is not a valid business purpose when the source of the cheap financing is the U.S. Treasury.

[12] The TAM Submission stated s% was the five-year fixed equivalent rate of US$LIBOR. This is consistent with Taxpayers' Supplemental Submission, which stated that the prevailing market interest rate at the time of the transaction was roughly w% and with the interest rate on the Senior Loan, which was s%.

[13] For the period beginning on Date 7 and ending on Date 8, Transferee transferred approximately $ll of the Securities to a partnership with respect to which it was allocated x% of the partnership items. Therefore, the taxable income and foreign tax credits reported by Transferee with respect to this period were somewhat lower.

substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly.

Second, the present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. Rather than making a direct loan to UK Parent, US Sub invested its $c in Issuer under a plan in which Issuer would invest those funds in Subsidiary, which would then loan the funds to UK Parent. The purpose of these steps was to create foreign tax credits that could be passed through Issuer to US Sub. Subsidiary incurred purported U.K. tax on the interest payments it received from UK Parent. By electing disregarded entity status for Subsidiary, the purported U.K. tax was passed through Issuer back to Taxpayers. No U.K. tax would have been incurred on a direct loan from US Sub to UK Parent. Thus, the various steps in the arrangement purportedly generated foreign tax credits, which would not have been available if US Sub had made a direct loan to UK Parent.

Taxpayers assert that the facts of this case are similar to those in Example 3 in Treas. Reg. §1.701-2(d). Example 3 illustrates the use of a partnership by a domestic corporation and a foreign corporation to conduct a bona fide joint business. In the example, each corporation will own a 50% interest in the business. The parties chose partnership form to enable the domestic corporation to qualify for a direct foreign tax credit under section 901 as opposed to indirect credits under section 902. The example illustrates only that a taxpayer has the flexibility to conduct business either through a partnership or a corporation, and a taxpayer may in some instances choose a classification based on favorable U.S. tax consequences. The example states that "maximizing [domestic corporation's] use of its proper share of foreign taxes paid by [the partnership], is consistent" with the intent of subchapter K. It is assumed in the example that the domestic corporation is a partner in a partnership with a bona fide business purpose. The facts of this case are in stark contrast to the facts of Example 3. In this case, Taxpayers lent money to the UK Parent through a circuitous route using Issuer and Subsidiary in order to create foreign tax credits for which Taxpayers did not bear the full economic cost. This is significantly different than the facts of Example 3 where the parties made a decision to conduct a bona fide business through a partnership. Here, Issuer had no real business purpose and merely served as a mechanism for Taxpayers to claim the foreign tax credits.

Based on the above analysis of the transaction and structure, it is determined that Issuer is not a partnership because Holders are lenders, not partners, and thus no partnership exists. Therefore, Issuer should be disregarded in whole and Holders are not entitled to either the disproportionate allocation of interest income or the purported U.K. taxes. Rather, Holders should be treated as lending directly to, and earning interest directly from, UK Parent.

Issue #4

Taxpayers and UK Parent formed Issuer and Subsidiary and routed Taxpayer's investment through those entities solely to generate the foreign tax credits at issue in this case. Taxpayers agreed to forgo a portion of the interest they would have earned on a direct loan and instead to provide below-market financing to UK Parent because of the foreign tax credits (and resulting U.S. tax savings). The use of Issuer and Subsidiary lacked economic substance because it served no legitimate non-tax purpose and had no objective economic substance. Therefore, the use of those entities and the foreign tax credits must be disregarded.

The economic substance doctrine allows the government to disregard a transaction and the related U.S. tax consequences when the transaction has no economic substance aside from tax consequences. See Black & Decker Corp. v. U.S., 436 F.3d 431, 441 (4th Cir. 2006).[14] In applying the economic substance doctrine, courts focus their analysis on the specific transaction that generates the tax benefits at issue. See Black & Decker, 436 F.3d at 441; Coltec Industries Inc. v. U.S., 454 F.3d 1340, 1356 (Fed. Cir. 2006); Nicole Rose Corp. v. Comm'r, 320 F.3d 282 (2d Cir. 2002); ACM Partnership v. Comm'r, 157 F.3d 231 (3d Cir. 1998). The courts examine two factors in evaluating whether that transaction lacks economic substance: whether the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and whether the transaction lacks objective economic substance because it has no reasonable possibility of profit. Black & Decker, 436 F.3d at 441; Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001). Certain courts apply a rigid two-prong test, while other courts treat business purpose and objective economic substance merely as factors to be considered in determining whether a transaction has economic substance. Compaq, 277 F.3d at 781. In considering the two factors, the inquiry "is directed to the same question: whether the transaction contained economic substance aside from tax consequences." Black & Decker, 436 F.3d at 441 (citing Hines v. U.S., 912 F.2d 736, 739 (4th Cir. 1990)).

Under the case law, the first step in analyzing whether a transaction lacks economic substance is to determine the specific "transaction" whose tax consequences are in dispute. Here, the tax consequences in dispute are the foreign tax credits claimed by Taxpayers. The arrangement between Taxpayers and UK Parent involved a transfer of $c in return for periodic payments of cash for five years and a return of $c at the end of those five years. If US Group and UK Parent had engaged in a direct, two-party transaction, no foreign taxes would have been due and no foreign tax credits

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[14]Transactions that lack economic substance are shams in substance. Such transactions are distinguishable from transactions that are shams in fact. A sham in fact is a transaction that is not real, i.e., a transaction that did not actually occur. If a transaction is a sham in fact a court will disregard the transaction for U.S. tax purposes, and will not inquire into whether the transaction is a sham in substance. See Mahoney v. Commissioner, 808 F.2d 1219, 1220 (6th Cir. 1987). We assume for purposes of this advice that the transaction at issue here actually occurred and, thus, is not a sham in fact.

would have been generated. Instead, the parties undertook additional steps, which had the effect of generating the foreign tax credits at issue. Specifically, US Group and UK Parent created Issuer and Subsidiary and inserted these specially created entities into the arrangement. It is these additional steps (the creation and use of Issuer and Subsidiary) that generated the foreign tax credits and, thus, must be examined to determine whether they lack economic substance.

Therefore, the issue is whether the creation and use of Issuer and Subsidiary (referred to as the "transaction" for purposes of this discussion) lacked economic substance because (1) Taxpayers were motivated by no business purpose other than obtaining tax benefits in entering the transaction, and (2) the transaction had no objective economic substance because there was no reasonable possibility of profit. See ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 512 (D.C. Cir. 2000) (stating that the sham analysis is the same "whether the 'sham' be in the entity or the transaction"). The sole purpose for the transaction was to generate foreign taxes that Taxpayers could claim as credits and, thereby, shelter Taxpayer's return from U.S. tax. The transaction was not reasonably expected to increase Taxpayers' economic return or reduce Taxpayers' credit risk. Because the transaction served no legitimate non-tax purpose and was not reasonably expected to enhance Taxpayers' economic position, the transaction lacks economic substance.

Taxpayers claim the purpose for entering into the transaction was two-fold: one, to reduce credit risk and two, to increase pre-tax profit. As explained above, the transaction did not reduce Taxpayers' credit risk. See Issue #3. Taxpayers' claim that the transaction increased their pre-tax profit is similarly without merit.

The TAM Submission states that the five-year fixed equivalent rate of US$LIBOR was s% at the time of the transaction. This is consistent with Taxpayers' Supplemental Submission, which states that the prevailing interest rate at the time of the transaction was "roughly" w%. Taxpayers' position is that the disproportionate allocations of the interest income earned on the Senior Loan constitute an enhanced profit (before U.S. and U.K. tax) of approximately y%.[15] Taxpayers argue that this purported enhanced profit reflects a sharing of UK Parent's U.K. tax benefits. Taxpayers' position is that UK Parent was willing to provide Taxpayers with a greater return (before U.S. and U.K. tax) because UK Parent obtained two deductions for U.K. tax purposes: one for interest paid to Subsidiary on the Senior Loan and one for the net losses of Issuer that were surrendered to UK Parent. Thus, Taxpayers argue UK Parent was able to obtain "cheap" financing on an after-U.K. tax basis.

[15] Pursuant to the Instrument, Taxpayers and UK Sub1 were to be allocated 99% and 1%, respectively, of Issuer's interest income even though Taxpayers contributed r% of the total capital of Issuer and UK Sub1 contributed v%. Based on these allocations, Taxpayer's position is that it obtained a return (before U.S. and U.K. tax) of approximately y%. We note that Taxpayers' purported return would be smaller if US Corp's payments pursuant to the interest-rate swap are taken into account.

Taxpayers' characterization of the transaction is contrary to the facts. The facts show that the transaction did not result in any additional U.K. tax benefits for UK Parent that it could "share" with Taxpayers.[16] Rather, the facts show that the sole benefit obtained from the transaction was the foreign tax credit and that this benefit was shared among the parties (through a below-market rate of return on the Securities) and the U.K. fisc (through a smaller deduction for UK Parent and corresponding increase in U.K. tax). In summary, due to the foreign tax credit, the U.S. tax decreased by $mm ($gg - $kk) while US Parent's after-tax return increased by $nn ($uu -$qq), UK Parent's after-tax cost declined by $oo ($ww -$ss) and U.K. tax increased by $pp ($rr -$vv).

This is readily apparent when the results for the parties are compared to the results of a direct loan from Taxpayers to UK Parent. Assuming an interest rate of s%, US Parent would have earned approximately $ff of interest annually on a direct loan, which would have resulted in U.S. tax of approximately $gg and an after-tax return to US Parent of approximately $qq. The $ff of interest would have generated $rr of U.K. tax savings for UK Parent, resulting in an after-tax cost to UK Parent of $ss.

In the transaction, Taxpayers were entitled to a rate of only u% on the Securities issued by Issuer and, thus, received only $tt in annual Yield Payments from Issuer. However, Taxpayers also obtained foreign tax credits of $ii. Accordingly, while Taxpayers' pre-credit U.S. tax was $jj ($hh of distributive share income x 35%), the amount of U.S. tax due was only $kk and Taxpayers' annual after-tax return was $uu. The net result for UK Parent was the $tt payment on the Securities, which resulted in U.K. tax savings of $vv and an after-tax cost to UK Parent of $ww. Thus, the amount of U.S. tax declined by $mm while US Parent's after-tax return increased by $nn, UK Parent's after-tax cost declined by $oo and the amount of U.K. tax increased by $pp.[17]

As this comparison shows, the transaction generated foreign tax credits and resulting U.S. tax savings of $mm and a net benefit for the parties of $xx ($mm U.S. tax savings offset by the $pp additional U.K. tax). This net benefit was shared by the parties: an increase of $nn for Taxpayers and an "increase" of $oo for UK Parent.

Taxpayers' claimed enhanced pre-tax profit from the disproportionate allocations of the interest income on the Senior Loan is illusory. The interest on the Senior Loan merely

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[16] The interest income recognized by Subsidiary equaled the amount of interest expense deductions claimed by UK Parent on the Senior Loan. Thus, the U.K. taxes owed by Subsidiary were fully offset by U.K. tax savings at the UK Parent level, and the transaction resulted in a single deduction for U.K. tax purposes equal to the amount of cash distributions made by Issuer to Holders on the Securities (consistent with the substance of the arrangement as a debt arrangement).

[17] The amounts used are approximate amounts. The amounts are consistent with the information provided by Taxpayers in their Supplemental Submission and with the principal amounts of the Securities and the Senior Loan and the stated rates on those instruments. We note, however, that there is a discrepancy between these amounts and the amounts of income and U.K. tax identified in the original TAM Submission as being reported by Taxpayers.

shifted UK Parent's U.K. taxes on unrelated income to Subsidiary (through the interest deduction at the UK Parent-level and the corresponding interest income at the Subsidiary-level) so that Taxpayers could claim foreign tax credits for those taxes. The interest that was disproportionately allocated to Subsidiary was used to pay the U.K. tax owed by Subsidiary, and was calculated precisely to result in a return for Taxpayers equal to the agreed Yield Payments of u%, which was below the prevailing interest rate at the time of the transaction.

Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004), aff'd on other grounds, 150 Fed. Appx. 40 (2d Cir. 2005), also involved a situation where a taxpayer's structured investment resulted in a pre-tax profit that was less than the amount of pre-tax profit the taxpayer would have made through a direct investment with the same amount of risk. As the court stated in that case,

> Under the circumstances here, the loan to OTC and a potential direct investment in Portfolio were from an objective standpoint identical investments, and it is the selection of the manner in which the investment was achieved - through OTC with attendant forfeiture of profit in exchange for no (or minimal) corresponding diminution in risk over a direct investment - that reveals the absence of objective economic substance and strongly suggests the sole focus as the creation of tax benefits.

330 F.Supp. 2d. at 183. See also ASA Investerings, 201 F.3d at 516 (noting that there was no reason to believe taxpayer could not have realized the economic benefits it sought at far, far lower transaction costs without the use of the partnership at issue in the case).

The forgoing analysis reveals that the transaction lacks economic substance. The transaction served no legitimate non-tax purpose because it did not reduce the Taxpayers' credit risk and was not undertaken to increase Taxpayer's pre-tax profit. The transaction did not have objective economic substance because it did not enhance Taxpayers' economic position. Rather, it resulted in a lower economic rate of return.

Moreover, if the transaction were regarded, Taxpayers would subvert the purpose of the foreign tax credit. The purpose of the foreign tax credit is to mitigate double taxation of foreign source income. It is inconsistent with the purpose of the foreign tax credit to permit a credit for foreign taxes that result from intentionally structuring a transaction to generate U.S. foreign tax credits for pre-existing foreign tax liabilities on a foreign counterparty's income that is shifted into a special purpose vehicle. Rather than provide the double tax relief that Congress intended, the foreign tax credits in this case would provide Taxpayers with the unintended benefit of reducing U.S. tax on Yield Payments that were not in substance subject to any foreign tax.

Taxpayers did, however, make an investment that had economic substance. US Sub advanced $c of funds, which ultimately ended up with UK Parent. Taxpayers received periodic payments with respect to those funds for five years, at the end of which time the funds were returned. The advance of funds to UK Parent and the periodic payments received by Taxpayers must be given effect for U.S. tax purposes. As discussed above (Issues #2 and #3), Taxpayers' investment was in the nature of debt. Accordingly, Taxpayers must recognize interest income in the amount of the cash payments received on the Securities.[18]

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

[18]We note that even if Taxpayers' investment were viewed as an equity investment in UK Parent for U.S. tax purposes, Taxpayers would not be entitled to claim foreign tax credits. If the investment were an equity investment in UK Parent, i.e., stock of UK Parent, Taxpayers would have dividend income in the amount of the payments on the Securities, but could not claim deemed-paid credits under section 902 because they would not be qualified domestic shareholders for purposes of section 902.