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March 22, 2007

Hon. Mark. W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Proposed Regulations Regarding the Identity of the Taxpayer for Purposes of Section 901 and 903

Dear Commissioner Everson:

Enclosed are Comments on proposed regulations regarding the identity of the taxpayer for purposes of section 901 and 903. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

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COMMENTS ON PROPOSED REGULATIONS REGARDING THE IDENTITY OF THE TAXPAYER FOR PURPOSES OF SECTIONS 901 AND 903

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Dirk Suringa, as Vice Chair of the Foreign Tax Credit Subcommittee of the Committee on Foreign Activities of U.S. Taxpayers (“FAUST”). Substantial contributions were made by Michael Caballero, Alan Cathcart, Jeff Korenblatt, Kim Majure, and Kevin Rowe. The Comments were reviewed by Rebecca Rosenberg as Chair of the Foreign Tax Credit Subcommittee of FAUST, Mark Harris, Vice Chair of FAUST, and Giovanna Sparagna, Chair of FAUST. The Comments were also reviewed by Phil West of the Section’s Committee on Government Submissions and Stephen E. Shay, Council Director for FAUST.

Although the members of the Section of Taxation who participated in preparing these Comments and/or other members of the Section of Taxation have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Executive Summary

These Comments address the proposed regulations (the “Proposed Regulations”)¹ relating to the determination of who is considered to pay a foreign tax for purposes of sections 901 and 903 of the Internal Revenue Code of 1986, as amended (the “Code”)².

The Proposed Regulations address transactions that involve the separation of foreign taxes from related foreign income. The Proposed Regulations would amend the section 901 Regulations regarding the identity of the person considered to pay a foreign tax for U.S. federal income tax purposes. Existing Regulations, issued in 1983 (the “1983 Regulations”), treat the person upon whom foreign law imposes legal liability for the tax as the taxpayer (the “Technical Taxpayer Rule”). The Proposed Regulations would amend the existing regulations generally to treat foreign law as imposing legal liability on the person whom foreign law requires to take into account the income subject to the foreign tax. The Proposed Regulations for this purpose would treat foreign law as allocating income among a group of persons that compute their income on a combined basis. The Proposed Regulations also would provide special rules for determining the identity of the taxpayer in the case of so-called “hybrid” and “reverse-hybrid” structures, the tax characterization of which differs between U.S. and foreign law.

As discussed in Part IV of these Comments, the Proposed Regulations in the view of some of our members raise questions regarding the scope of the statutory authority for their issuance.

Our specific recommendations regarding the Proposed Regulations are found in Parts V and VI of the Comments. They are summarized as follows:

1. The Proposed Regulations should be revised to provide in specific cases that the beneficial owner of income-producing property is the taxpayer entitled to a foreign tax credit for withholding taxes imposed when the property is held by a nominee.
2. The Proposed Regulations, when finalized, should not adopt a general rule that characterizes all hybrid instruments and payments in a particular manner. If the final regulations do contain a hybrid payment rule of general application (rather than a rule targeting abusive transactions), we recommend that the Internal Revenue Service (the “IRS”) and the Department of Treasury (“Treasury”) apply the rule on a prospective basis.
3. The Proposed Regulations, when finalized, should provide additional guidance regarding when a group of entities computes its income on a “combined basis.”

¹ Notice of Proposed Rulemaking, REG-124152-06, 71 Fed. Reg. 44,240 (Aug. 4, 2006).

² All references to “sections” are to the Code, unless otherwise noted.

4. The Proposed Regulations, when finalized, should apply prospectively.
5. The Proposed Regulations, when finalized, should clarify that excess foreign tax credits carried forward from pre-2007 tax years to post-2006 tax years remain with the taxpayer that was eligible to claim such credits under the regulations that applied to the year in which the foreign taxes were paid or accrued, even if that person would not be the taxpayer under the Proposed Regulations in the carryforward year. Similarly, the Proposed Regulations, when finalized, should clarify that taxes paid or accrued in the first post-2006 year and carried back to the last pre-2007 year are treated in the carryback year as paid or accrued by the taxpayer who was eligible to claim the associated credits under the Proposed Regulations, as finalized.
6. We recommend that the Proposed Regulations, when finalized, in the case of hybrid partnerships, allocate the foreign taxes to periods beginning before and after a section 708 or section 706 event based on the allocation of the related foreign income. We further recommend that the Proposed Regulations, when finalized, apply these allocation rules to section 708 terminations that arise under section 708(b)(1)(A) in the case of a partnership that has ceased its operations.
7. The Proposed Regulations, when finalized, should permit multiple owners of the same security to agree to allocate withholding taxes imposed on income generated by the security in proportion to the income each owner accrued on the security.
8. The Proposed Regulations, when finalized, should provide that the actual payment by a reverse hybrid of the tax allocated to it under the Proposed Regulations, as finalized, does not create a deemed distribution to the owner of the reverse hybrid. The Proposed Regulations, when finalized, should apply the same rule to the reimbursement by the reverse hybrid of a foreign tax payment made by its owner with respect to the owner's distributive share of income under foreign law.
9. The Proposed Regulations, when finalized, should clarify their interaction with bilateral U.S. income tax treaties.
10. The Proposed Regulations, when finalized, should clarify the application of the Combined Income Rule to reverse hybrids where the owner of the reverse hybrid earns income directly from the jurisdiction of residence of the reverse hybrid.
11. The Proposed Regulations, when finalized, should clarify the interaction of the rules for reverse hybrids, disregarded entities, and hybrid

partnerships and provide one or more examples illustrating such interaction.

COMMENTS

I. Introduction

This submission presents our Comments on the Proposed Regulations relating to the determination of who is considered to pay a foreign tax for purposes of sections 901 and 903.

Our detailed comments are set forth in Parts IV, V, and VI.

II. History, Background, and Purpose of the Proposed Regulations

The Proposed Regulations attempt to address certain transactions involving the separation of foreign taxes from related foreign income. Such transactions were considered in certain cases to produce results inconsistent with the purpose of the foreign tax credit, which is to mitigate double taxation of foreign source income without relinquishing primary U.S. taxing jurisdiction over U.S. source income.³

In Notice 2004-19, the IRS and Treasury withdrew Notice 98-5,⁴ and its reliance on an economic profits test to identify abusive foreign tax credit transactions. That test would have disallowed foreign tax credits if the reasonably expected economic profit from an arrangement was insubstantial compared to the expected foreign tax credit. Notice 2004-19 withdrew that test and promised instead forthcoming guidance “concerning the application of the legal liability rule of §1.901-2(f) in certain circumstances, including, for example, in the case of consolidated tax reporting systems in foreign countries.” Those regulations would promulgate “rules that make the allocation of foreign taxes imposed on the combined income of two or more persons more consistent with each person’s respective share of the foreign income to which the tax relates.”

On March 31, 2005, the Court of Federal Claims issued its opinion in *Guardian Industries v. United States* (“*Guardian*”).⁵ In that case, the court held that Guardian was entitled to claim a U.S. foreign tax credit for foreign taxes imposed on its wholly owned disregarded entity, which was the parent of a foreign affiliated group of foreign corporations. The taxpayer owned all the stock of a Luxembourg holding company (“GIE”), which, in turn, owned directly or indirectly substantially all the stock of ten lower-tier Luxembourg companies. GIE and its direct and indirect subsidiaries constituted a “fiscal unitary group,” which reports income under Luxembourg law on a consolidated basis (the “GIE Group”).

The taxpayer elected to treat GIE as a disregarded entity for U.S. tax purposes, but the other GIE Group members remained corporations for U.S. tax purposes. The taxpayer took the position that the Technical Taxpayer Rule treated Guardian as the taxpayer for purposes of the entire Luxembourg tax. Guardian was treated as paying the entire tax imposed on the GIE Group, even though Guardian was not required to take into account currently the income of other Group members for U.S. income tax purposes. The IRS disallowed the claimed foreign tax

³ See Notice 2004-19, 2004-11 I.R.B. 606, 607.

⁴ 1998-1 C.B. 334.

⁵ 65 Fed. Cl. 50 (2005).

credit and argued that the GIE Group members were jointly and severally liable for the group income tax under Luxembourg law. The IRS argued that the 1983 Regulations therefore allocated the income and foreign taxes of the GIE Group among its members.

The Court of Federal Claims held that under Luxembourg law only GIE had legal liability for the income tax imposed on income of the group. Because there was no joint and several liability for the tax, Guardian could claim a credit for the full amount of the foreign tax, even though Guardian did not have to report the income earned by the lower-tier GIE Group members, which were treated as corporations for U.S. tax purposes. The Department of Justice filed an appeal in *Guardian*. On February 23, 2007, the Federal Circuit Court of Appeals held in favor of the taxpayer, holding that based on the relevant U.S. tax regulations and Luxembourg laws, GIE is the party liable for the tax under Luxembourg law within the meaning of Reg. § 1.901-2(f)(1).⁶

III. Description of the Proposed Regulations

The 1983 Regulations state the Technical Taxpayer Rule, which traces its origins to the 1938 case of *Biddle v. Commissioner*.⁷ According to the Technical Taxpayer Rule, the taxpayer for purposes of sections 901 and 903 is “the person on whom foreign law imposes legal liability for such tax, even if another person (*e.g.*, a withholding agent) remits such tax.”⁸ This rule is referred to as the Technical Taxpayer Rule because it relies upon an administratively convenient technicality, foreign legal liability, to determine the incidence of the foreign tax for purposes of section 901. The primary policy justification for the Technical Taxpayer Rule is administrative simplicity. The economic incidence of a foreign tax is too elusive a criteria to use to allocate the credit. In addition, the person upon whom foreign law imposes legal liability typically is in the best position to prove an entitlement to the credit and to challenge the foreign tax if necessary.⁹

The Proposed Regulations would revise the Technical Taxpayer Rule by providing that “foreign law is considered to impose legal liability for tax on income on the person who is required to take the income into account for foreign income tax purposes.”¹⁰ Consistent with this general rule, the Proposed Regulations also would provide that foreign law is considered to impose legal liability for withholding taxes on “the owner of the base on which the tax is imposed for foreign tax purposes.”¹¹

The 1983 Regulations apportion a foreign income tax liability among related persons if foreign law imposes on them joint and several liability for the tax.¹² This apportionment is based on each person’s portion of the foreign income subject to tax. The Proposed Regulations would eliminate the joint and several liability requirement. They would allocate foreign taxes among two or more persons if they compute their income on a “combined basis” under foreign law (the

⁶ *Guardian Indus. Corp. vs. United States*, No. 2006-5058, 2007 WL 542706 (Fed. Cir. Feb 23, 2007)

⁷ 302 U.S. 573 (1938). See *infra* text accompanying note 34 for a discussion of *Biddle*.

⁸ Reg. § 1.901-2(f)(1).

⁹ See Notice of Proposed Rulemaking, 71 Fed. Reg. at 44,241.

¹⁰ Prop. Reg. § 1.901-2(f)(1)(i).

¹¹ Prop. Reg. § 1.901-2(f)(1)(ii).

¹² Reg. § 1.901-2(f)(3).

“Combined Income Rule”).¹³ The Proposed Regulations do not define the term “combined basis.” However, they do state that the Combined Income Rule would not be triggered by mere application of a group-relief regime (such as in the United Kingdom), an integrated tax system, or a foreign anti-deferral regime.¹⁴

The 1983 Regulations provide no specific rules regarding reverse hybrids (entities treated as a corporation for U.S. tax purposes and as a pass-through entity for foreign tax purposes), which are simply governed by the general rule focusing on legal liability. Under this approach, the owners of a reverse hybrid generally are treated as the technical taxpayer, and entitled to a foreign tax credit for taxes attributable to the reverse hybrid’s income, even though such income is not currently subject to U.S. taxation. Accordingly, the effect of a reverse hybrid structure is to separate foreign tax credits from the related income. The Proposed Regulations change the treatment of foreign taxes attributable to the income of reverse hybrids. For these purposes, the Proposed Regulations define the term “reverse hybrid” as any corporation for U.S. income tax purposes if another person (for discussion purposes, the “Partner”) is required to take into account all or part of the corporation’s income under foreign law because foreign law treats the corporation as a pass-through entity.¹⁵

The Proposed Regulations would impose the Combined Income Rule on reverse hybrids: they would treat the tax liability imposed on the Partner as imposed on the combined income of the Partner and the reverse hybrid. For this purpose, however, the Proposed Regulations would treat the reverse hybrid as the earner of any income allocated by the reverse hybrid to the Partner under foreign law. In this regard, the Proposed Regulations do not follow the foreign-law designation of the income earner. If the Partner has no other income subject to tax by the foreign country, then the Proposed Regulations would simply allocate the entire foreign tax to the reverse hybrid.

The 1983 Regulations do not discuss in detail how to apportion legal liability among persons subject to joint and several liability under foreign law. The Proposed Regulations would provide guidance on how to determine each person’s portion of the income subject to the Combined Income Rule. If foreign law imposes tax on the income of more than two persons and any of them has a net loss for the year, then the Proposed Regulations would follow any mandatory foreign legal provision that allocates the loss. If foreign law does not contain a mandatory allocation rule, then the Proposed Regulations would allocate the loss pro rata.

The Proposed Regulations would not give effect to dividends or deemed dividends taken into account in computing combined income under foreign law. However, the Proposed Regulations would give effect to interest, rents, royalties, and other payments between foreign persons subject to the Combined Income Rule, provided that the U.S. and foreign tax treatment of the payments match.¹⁶ The Proposed Regulations reserve on the treatment of hybrid instruments. For instance, the Proposed Regulations provide no guidance on the treatment under the Combined Income Rule of payments on an instrument treated as debt for foreign tax

¹³ Prop. Reg. § 1.901-2(f)(2)(i).

¹⁴ Prop. Reg. § 1.901-2(f)(2)(ii).

¹⁵ Prop. Reg. § 1.901-2(f)(2)(iii).

¹⁶ Prop. Reg. § 1.901-2(f)(2)(iv)(B).

purposes but equity for U.S. tax purposes.¹⁷ Instead, the preamble to the Proposed Regulations (the “Preamble”) requests comments on this issue, and also states that

The IRS and Treasury Department are continuing to study certain transactions employing hybrid instruments and other transactions designed to generate inappropriate foreign tax credit results. These include the use of hybrid instruments that accrue income for foreign tax purposes, but not U.S. tax purposes, to accelerate the payment of creditable foreign taxes before related income is subject to U.S. tax. These also include the use of disregarded payments to shift foreign tax liabilities away from the person that is considered to earn the associated taxable income for U.S. tax purposes. It is contemplated that some or all of these issues will be addressed in a separate guidance project, and that any such regulations may also be effective for taxable years beginning on or after January 1, 2007.¹⁸

The 1983 Regulations provide that a foreign tax is paid by the taxpayer even if another party agrees by contract to assume the taxpayer’s foreign tax liability. The Proposed Regulations would preserve this rule¹⁹ and further provide that “U.S. tax principles” apply to determine the tax consequences if one person remits a tax that the Proposed Regulations treat as being paid by another person.²⁰ For example, if the Proposed Regulations treat a reverse hybrid as the taxpayer, payment of the reverse hybrid’s tax by the Partner would be treated as a capital contribution, and reimbursement of the Partner’s payment by the reverse hybrid would be treated as a distribution.²¹

The 1983 Regulations contain no rules regarding the treatment of so-called “hybrid partnerships.” The Proposed Regulations provide guidance in this area. They would define a hybrid partnership as any entity treated as a partnership for U.S. income tax purposes if foreign law imposes tax on it at the entity level.²² The Proposed Regulations would treat the hybrid partnership itself as legally liable for the tax under foreign law. Existing partnership allocation rules would attribute the tax to the partners. The Proposed Regulations also would deal with deemed partnership terminations that are ignored for foreign tax purposes. They would allocate the foreign tax paid or accrued by the partnership between the terminating partnership and the new partnership on a temporal basis.

The 1983 Regulations do not discuss the treatment of entities disregarded for U.S. federal income tax purposes pursuant to an entity classification election. The Proposed Regulations would treat a tax liability imposed on the disregarded entity as imposed on the U.S. tax owner of its assets.²³ The Proposed Regulations would provide allocation rules, similar to those for hybrid

¹⁷ Prop. Reg. § 1.901-2(f)(4).

¹⁸ Notice of Proposed Rulemaking, 71 Fed. Reg. 44,240, 44,243 (Aug. 4, 2006).

¹⁹ See Prop. Reg. § 1.901-2(f)(5).

²⁰ Prop. Reg. § 1.901-2(f)(2)(v).

²¹ See *id.*

²² Prop. Reg. § 1.901-2(f)(3)(i).

²³ Prop. Reg. § 1.901-2(f)(3)(ii).

partnerships, where the ownership of the disregarded entity changes mid-year for U.S. tax purposes but the entity does not dissolve for foreign tax purposes.

The Proposed Regulations would be effective January 1, 2007.²⁴ They do not provide transition rules.

The Preamble invites comments regarding the treatment of withholding taxes imposed on a person who receives income on behalf of a beneficial owner of the income. The Preamble notes that the foreign country may treat the income recipient in that case as the income earner, while the United States considers the income recipient to be a mere nominee.

Comments should focus on how a special rule for such nominee arrangements could be narrowly drawn to prevent opportunities for abuse while maintaining the administrative advantages of the legal liability rule, which generally operates to classify as the taxpayer the person who is in the best position to prove the tax was required to be, and actually was, paid.²⁵

This statement implies that under the general approach of the Proposed Regulations the nominee would be treated as the taxpayer, which would result in a split between the income and the credit. The exception, for which comments are requested, presumably would allocate the credit to the beneficial owner of the income for U.S. tax purposes, regardless of the foreign-law treatment of the nominee.

The Proposed Regulations also request additional comments regarding the appropriate application of the legal liability rule to hybrid instruments and payments that are disregarded for U.S. tax purposes.

IV. Statutory Authority

The Preamble states that commentators have expressed different views on whether the IRS and Treasury currently have sufficient regulatory authority to extend the scope of the regulations under section 901 to require the attribution of foreign tax to reverse hybrids.²⁶ Nevertheless, the IRS and Treasury concluded that “the proposed regulations are well within applicable regulatory authority and fully consistent with the case law, including *Biddle v. Commissioner*.”²⁷ The Preamble also states that the Proposed Regulations are intended to

²⁴ Prop. Reg. § 1.901-2(h).

²⁵ 71 Fed. Reg. 44,240, 44,241 (Aug. 4, 2006).

²⁶ Compare New York State Bar Ass’n, Tax Section, Report on Regulation Section 1.901-2(f)(3) and the Allocation of Foreign Taxes Among Related Persons, at 29 (Apr. 4, 2005) (concluding that the IRS and Treasury have regulatory authority to address the separation of foreign taxes and income) with Letter from Judy Scarabello, National Foreign Trade Council, Inc. to Harry J. Hicks, III, International Tax Counsel, Department of the Treasury (Nov. 4, 2005) (questioning whether IRS and Treasury have such authority).

²⁷ 71 Fed. Reg. at 44,243.

update and clarify the application of the legal liability rule. It is unclear whether the IRS and Treasury believe that the Proposed Regulations reflect current law.²⁸

We believe that the Proposed Regulations would modify the legal liability rule. Neither section 901 nor the 1983 Regulations explicitly treat the income earner, under foreign law, as the taxpayer. Certain withholding tax cases do appear to link income inclusion and foreign legal liability.²⁹ These cases, however, do not purport to create a universal rule that reaches, for example, net-basis foreign taxes, and the holdings in some of the cases can be explained on other grounds.³⁰ We therefore believe it is legitimate to inquire as to, and important for IRS and Treasury to explain, the basis for their assertion that they currently have the authority to promulgate the Proposed Regulations.

We conclude that the IRS and Treasury do have the authority under current law to provide as a general matter that foreign law is deemed to impose legal liability on the income earner under foreign law. Certain of our members, however, have expressed concern that the IRS and Treasury may have exceeded their authority to the extent the Proposed Regulations allocate the credit to persons who are neither the income earner under foreign law nor legally liable under foreign law. The Proposed Regulations appear to adopt such an approach with respect to reverse hybrids. To reflect the views of these members, we consider the question of regulatory authority.

In our view, the Proposed Regulations are interpretive regulations.³¹ Congress has not yet granted Treasury specific authority to “prescribe regulations disallowing a credit . . . for all or a portion of any foreign tax, or allocating a foreign tax among 2 or more persons, in cases where the foreign tax is imposed on any person in respect of income of another person or in other cases involving the inappropriate separation of the foreign tax from the related foreign income.”³² At

²⁸ See, e.g., Appellant’s Brief, *Guardian Indus. Corp. v. Commissioner*, Docket No. 2006-5058, at *19 (May 25, 2006) (“Our sole argument is that Treas. Reg. § 1.901-2(f)(1) requires the Luxembourg tax to be allocated among the members of GIE’s Luxembourg group in proportion to each member’s share of the consolidated taxable income.”).

²⁹ See *Norwest Corp. v. Commissioner*, 69 F.3d 1404, 1407 (8th Cir. 1995); *Continental Illinois Corp. v. Commissioner*, 998 F.2d 513, 519 (7th Cir. 1993); *Nissho Iwai American Corp. v. Commissioner*, 89 T.C. 765, 774 (1987); *Gleason Works v. Commissioner*, 58 T.C. 464, 479 (1972).

³⁰ See, e.g., *Norwest Corp.*, 69 F.3d at 1407 (“The Commissioner’s argument is unduly formalistic because Brazilian banking authorities will not allow the Brazilian borrower to buy foreign currency to pay interest to foreign lenders without proof it has withheld and paid the local tax.”). The case of *Abbot Laboratories International Co. v. United States*, 160 F. Supp. 321 (1958), *aff’d*, 267 F.2d 940 (7th Cir. 1959), appears to provide the strongest support for treating the income earner as the taxpayer. See 160 F. Supp. at 329. The IRS, however, appears to have rejected the approach of *Abbot Laboratories* in published guidance, which has not been withdrawn. See Rev. Rul. 72-197, 1972-1 C.B. 215; Rev. Rul. 58-518, 1958-2 C.B. 381. The current regulations, moreover, allocate foreign taxes based on income only in situations where foreign law imposes joint and several liability.

³¹ Legislative regulations are issued pursuant to a specific grant of authority by Congress, and they are accordingly entitled to particular deference by courts. Legislative regulations are upheld “unless arbitrary, capricious, or manifestly contrary to the statute.” *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984). By contrast, interpretive regulations, issued pursuant to section 7805(a), are valid if they implement a congressional mandate in a reasonable manner. *Cottage Sav. Ass’n v. Commissioner*, 499 U.S. 554, 560-61 (1991); *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982); *Rowan Cos. v. United States*, 452 U.S. 247, 252 (1981); *United States v. Cartwright*, 411 U.S. 546, 550 (1973); *National Muffler Dealers Association v. United States*, 440 U.S. 472, 477 (1979).

³² S. 1637, 108th Cong., § 661A, (2004); see also H.R. Conf. Rep. No. 108-755, at 784 (2004) (declining to adopt the Senate amendment).

the same time, Congress has enacted sections 901(k) and 901(l), which deny the foreign tax credit with respect to particular transactions that inappropriately separate income from credit. Congress carefully declined to impart meaning to its refusal to grant broadened regulatory authority to the IRS and Treasury,³³ but in our view the Proposed Regulations are interpretive, not legislative, in character.

Under existing precedent, interpretive regulations are valid if they implement a Congressional mandate in a reasonable manner,³⁴ and we believe that the general approach of the Proposed Regulations reasonably implements the Congressional mandate of section 901. The Congressional mandate of section 901 is to mitigate double taxation of income.³⁵ Double taxation of income is predicated on both U.S. taxation and foreign taxation of the same income. A U.S. taxpayer that claims a foreign tax credit currently while deferring indefinitely U.S. taxation of the related income has obtained the credit without experiencing double taxation. The Proposed Regulations would reasonably implement the Congressional mandate because they attempt to link the U.S. foreign tax credit to the income subject to foreign tax.

While the general approach of the Proposed Regulations reasonably implements the Congressional mandate of section 901, some of our members believe that the rules regarding reverse hybrids may curtail certain aspects of the Technical Taxpayer Rule in a way that does not reasonably implement the Congressional mandate. They believe that *Biddle v. Commissioner* requires an examination of foreign law and that the Proposed Regulations do not abide by that requirement in respect of reverse hybrids.

In *Biddle v. Commissioner*, the Supreme Court identified “the taxpayer” for U.S. tax purposes by first examining who under foreign law had a “legal duty” to pay the tax.³⁶

[W]hether the stockholder pays the tax within the meaning of our own statute . . . must ultimately be determined by ascertaining from an examination of the manner in which the British tax is laid and collected what the stockholder has done in conformity to British law and whether it is the substantial equivalent of payment of the tax as those terms are used in our own statute.³⁷

The Court went on to say that U.S. law ultimately determines who is entitled to the foreign tax credit. The Court’s opinion regarding the role of foreign law is not entirely clear. Some of our members believe that it links the allocation of the foreign tax credit under U.S. law with the “legal duty” to pay the tax under foreign law.³⁸

In our view, *Biddle* does not preclude the IRS and Treasury from adopting a general rule that interprets foreign law to impose the legal duty to pay the tax on the person whom foreign

³³ See H.R. Conf. Rep. No. 109-455, at 264 (2006).

³⁴ *National Muffler Dealers Association v. United States*, 440 U.S. 472, 477 (1979).

³⁵ See *American Chicle Co. v. United States*, 316 U.S. 450, 452 (1942); *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932).

³⁶ *Biddle v. Commissioner*, 302 U.S. 573, 581 (1938).

³⁷ *Id.* at 579.

³⁸ *Id.* at 581.

law treats as the earner of the income. For instance, if foreign law treats A, but not B, as legally liable for a tax on income that foreign law treats B as earning, we believe that the Proposed Regulations, consistent with section 901, reasonably could treat B as legally liable for the tax.

In the case of reverse hybrids, however, some of our members believe that the Proposed Regulations disregard foreign law, and the “legal duty” to pay the tax, altogether. If a foreign entity constitutes a reverse hybrid under the Proposed Regulations, the Proposed Regulations treat the reverse hybrid as the income earner under foreign law, and liable for the tax under foreign law, even if foreign law explicitly treats the Partner as the income earner who is liable for the tax.³⁹ In the view of some of our members, this rule renders irrelevant both the identity of the income earner under foreign law and the legal duty to pay the tax under foreign law. In their view, these aspects of foreign law, relied upon by the *Biddle* Court as well as the Technical Taxpayer Rule, cannot be disregarded.⁴⁰ The Proposed Regulations also surrender administrability, in their view. If the Proposed Regulations allocate the tax liability to a person who is neither liable under foreign law for the tax nor the earner of the income subject to tax, that party might not have legal standing under foreign law to challenge the imposition of the tax, or the means to prove its entitlement to the credit under U.S. law.

Although the ability to challenge, or prove entitlement to the credit created by, the tax imposed under foreign law on the income of a reverse hybrid is a valid and practical concern, the majority of those commenting nevertheless believe that the IRS and Treasury do have authority to adopt the reverse hybrid rules contained in the Proposed Regulations. In their view, *Biddle* stands for the proposition that U.S. law determines the identity of the taxpayer, and that U.S. law for this purpose should include U.S. entity classification principles as well. Moreover, foreign law is not disregarded in that the determination of an entity’s status as a reverse hybrid relies on its fiscal treatment under foreign law (*i.e.*, whether under foreign law the income of the reverse hybrid passes through to its members). Finally, given the reality that a reverse hybrid is solely a U.S. federal tax “creature,” the IRS and Treasury should be allowed broader leeway in circumstances that may present the potential for tax abuse. Following this logic, the majority also believes that the Proposed Regulations, when finalized, should consistently extend the matching concept to other contexts, like nominee arrangements.

In light of these divergent views, we believe it would be helpful for the IRS and Treasury to explain more fully their assertion in the Preamble that the treatment of reverse hybrids is “well within applicable regulatory authority and fully consistent with the case law, including *Biddle v. Commissioner*.”

³⁹ Another aspect of the Proposed Regulations raises a similar issue. Under the Combined Income Rule, “[f]oreign tax is considered to be imposed on the combined income of two or more persons even if the combined income is computed under foreign law by attributing to one person (*e.g.*, the foreign parent of a foreign consolidated group) the income of other such persons.” Prop. Reg. § 1.901-2(f)(2)(ii). Although the Proposed Regulations generally follow the foreign income allocation, they do not do so here. In this context, they look instead to U.S. law.

⁴⁰ *Cf. Swallows Holding, Ltd. v. Commissioner*, 126 T.C. 96, 138 (2006) (invalidating an interpretive regulation on the ground that it “was an unreasonable attempt by the Secretary to circumvent the firmly established legal terrain.”).

V. Response to Request for Comments

A. Nominee Arrangements

The Preamble asks for comments on the situation where one person receives income subject to foreign withholding tax on behalf of another person (a “Nominee Arrangement”). Foreign law may treat the recipient as the earner of the income and impose legal liability for the tax on that person, while U.S. law may treat the recipient as a mere nominee receiving the income on behalf of its beneficial owner. In this situation, the general approach of the Proposed Regulations would appear to allocate to the nominee the foreign tax credit arising from the withholding tax because foreign law treats the nominee as the income earner.⁴¹ At the same time, the United States would treat the beneficial owner as the income earner and impose U.S. tax. In this way, the general approach of the Proposed Regulations would appear to split income from credit in a manner that could create double taxation or double non-taxation of income, assuming that the nominee passes on the cost of the foreign tax to the beneficial owner.

For instance, if the nominee is a foreign person and the beneficial owner is a U.S. person, then the Proposed Regulations could give rise to double taxation. The beneficial owner would be subject to current U.S. taxation, and also economically exposed to foreign taxation, without the benefit of the U.S. foreign tax credit. By contrast, if the nominee is a U.S. person and the beneficial owner a foreign person, then the U.S. person might obtain the foreign tax credit under the Proposed Regulations without being subject to U.S. tax and without bearing the economic burden of the foreign tax.

In our view, the risk of the latter outcome is somewhat attenuated by sections 901(k) and 901(l). If the United States treats the beneficial owner as the owner of the income-producing *asset*, as well as its income, then section 901(k) or section 901(l) presumably deny the nominee’s claim for the foreign tax credit, as it is not the owner for U.S. tax purposes. The nominee would not be considered to hold the asset that generated the income subject to foreign tax during the requisite holding period.

The Preamble asked for comments on a special rule that would link the income inclusion with the foreign tax credit. According to the Preamble, “[c]omments should focus on how a special rule for such nominee arrangements could be narrowly drawn to prevent opportunities for abuse while maintaining the administrative advantages of the legal liability rule, which generally operates to classify as the taxpayer the person who is in the best position to prove the tax was required to be, and actually was, paid.”⁴²

As an initial matter, a special rule for Nominee Arrangements could present the same concern identified above with respect to reverse hybrids: that is, whether the IRS and Treasury have sufficient interpretive authority simply to disregard foreign law and treat the beneficial owner for U.S. tax purposes as the taxpayer for purposes of section 901. Nevertheless, in our view, the IRS and Treasury have at least as much authority to match income and credit in the

⁴¹ Cf. Prop. Reg. § 1.901-2(f)(6) (Example 2) (allocating the foreign tax to the party who is the beneficial owner of the income under both U.S. and foreign law).

⁴² 71 Fed. Reg. 44,240, 44,241 (Aug. 4, 2006).

case of Nominee Arrangements as in the case of reverse hybrids. If the IRS and Treasury conclude that they do have interpretive authority to address reverse hybrids in the manner described above, we recommend that the Proposed Regulations, when finalized, apply the same general approach to Nominee Arrangements as well (*i.e.*, allocate the income and associated taxes between the nominee and the principal in accordance with U.S. tax principles).

We recommend that the Proposed Regulations, when finalized, first exclude certain common forms of property ownership from the special rule for Nominee Arrangements. For instance, the Proposed Regulations, when finalized, should clarify that a U.S. taxpayer is not required to prove that foreign law treats it as the beneficial owner of stock held by its broker in street name in order to claim a credit for withholding taxes imposed on dividends from the stock. A similar rule should apply to American Depository Receipts and other commonplace custodial arrangements. The Proposed Regulations, when finalized, also should clarify the treatment of securities lending arrangements and sale-repurchase transactions of the type described in Example 3 of the Proposed Regulations.⁴³ We understand that IRS and Treasury have received substantial comments regarding Example 3 and that you may revise the example based on those comments and internal review.⁴⁴

Having excluded clear cases, the Proposed Regulations, when finalized, then should create a special rule for Nominee Arrangements.⁴⁵ The purposes of this rule would be to enhance administrability of the regime and to prevent whipsaws. The rule would apply to any arrangement for which a foreign country considers the recipient of income to earn that income or be the owner of the tax base for purposes of imposing a withholding tax, while the United States considers the recipient to be a nominee receiving the income on behalf of the beneficial owner.

Under our proposal, foreign law would be considered to impose legal liability on the beneficial owner of the income if the Nominee Arrangement meets certain specified criteria. U.S. agency principles could provide the basis for selecting those criteria. The IRS employed an agency approach to identify the taxpayer for purposes of section 901 in Revenue Ruling 72-514.⁴⁶ In that ruling, a domestic corporation, X, appointed a third-party bank as its “escrow trustee” for the purpose of making loans to certain of X’s foreign subsidiaries. Applying U.S. agency principles to the agreement between X and the bank, the ruling concluded that X was entitled to a foreign tax credit for withholding taxes imposed on interest income paid by the foreign corporations to the bank for X’s account.

⁴³ See Prop. Reg. § 1.901-2(f)(6) (Example 3).

⁴⁴ We would be pleased to discuss this issue further with you and to submit additional comments if requested.

⁴⁵ We understand that you may be considering an exception for public companies, and we would be pleased to discuss this issue further with you and to submit additional comments if requested regarding that proposal.

⁴⁶ 1972-2 C.B. 440. U.S. tax law imputes the activities or assets of an agent to its principal in certain circumstances. See generally *Commissioner v. Bollinger*, 485 U.S. 340, 345 (1988); *National Carbide Corp. v. Commissioner*, 336 U.S. 422, 426-27 (1949). Common law agency concepts, as summarized by the Second Restatement of Agency, have influenced the development of agency concepts for U.S. federal income tax purposes. See, e.g., Rev. Rul. 74-331, 1974-2 C.B. 281 (citing the Restatement); Rev. Rul. 74-330, 1974-2 C.B. 278 (same). These agency authorities would be relevant to your consideration of our proposal.

Following this example, the Proposed Regulations, when finalized, could allocate the foreign tax credit to the beneficial owner in a Nominee Arrangement if it satisfied the following criteria:

1. The arrangement is evidenced by a written agreement.
2. The beneficial owner provides the funds used to acquire the income-producing asset.
3. The asset is acquired on or after the date the agreement is entered into.
4. Income received by the nominee with respect to the asset is held for the benefit of the beneficial owner and payable to the beneficial owner upon instruction.
5. The nominee bears no more than a de-minimis risk of loss or opportunity for gain from changes in the value of the income-producing property.
6. The nominee receives independent compensation for its services, either in the form of a separate fee or in the form of a retained spread.
7. The nominee and the beneficial owner report their arrangement to the IRS in order to avoid the potential for whipsawing the government.

We believe that adopting clear criteria such as these would help to maintain “the administrative advantages of the legal liability rule.” We further believe that this rule is narrowly drawn and that sections 901(k) and 901(l) (or regulations written under those sections) would protect against the risk that a taxpayer would deliberately fall outside this rule. If the beneficial owner were not considered to own the income-producing asset for requisite holding period provided in section 901(k)(1) or section 901(l)(1), no credit would be allowed, regardless of the proposed rule suggested above. Guidance issued pursuant to sections 901(k) and 901(l) also could provide exceptions to their unwarranted application in this context.⁴⁷

B. Hybrid Instruments

The Proposed Regulations contain a reservation on the treatment of hybrid instruments.⁴⁸ The Preamble states that the IRS and Treasury are studying “certain transactions employing hybrid instruments and other transactions designed to generate inappropriate foreign tax credit results.”⁴⁹ Targeted instruments and transactions are those designed to accelerate foreign taxes before inclusion of income subject to U.S. taxation and to shift foreign tax liabilities away from the person that earns the income for U.S. tax purposes.

⁴⁷ See, e.g., Notice 2005-90, 2005-51 I.R.B. 1163 (carving out certain back-to-back licensing arrangements from the scope of section 901(l)).

⁴⁸ Prop. Reg. § 1.901-2(f)(4).

⁴⁹ 71 Fed. Reg. 44,240, 44,243 (Aug. 4, 2006).

The Preamble warn that “some or all of these issues will be addressed in a separate guidance project, and that any such regulations may also be effective for taxable years beginning on or after January 1, 2007.” At the same time, the Preamble requests additional comments regarding the appropriate application of the legal liability rule to hybrid instruments and payments that are disregarded for U.S. tax purposes.

We fully support the efforts of IRS and Treasury to target abusive transactions that separate income from credits. We believe that such transactions should not be identified as listed transactions except on a case-by-case basis.⁵⁰ We believe that the Proposed Regulations, when finalized, should not adopt a general rule that characterizes all hybrid instruments and payments in a particular manner. The appropriate scope of such a rule, in our view, would be too difficult to define.

The Preamble, for example, speaks of both “hybrid payments” and “disregarded payments.” The spectrum of hybrid instruments is much broader than that of disregarded payments. Based on how they are described in the Preamble, hybrid payments could include payments that are disregarded for U.S. tax purposes but respected for foreign tax purposes, payments that are respected for U.S. tax purposes but disregarded for foreign tax purposes, payments that are respected for both U.S. and foreign tax purposes but treated differently under each system (*e.g.*, a payment treated as a taxable dividend for U.S. purposes and a deductible interest payment for foreign purposes), and payments that are respected for both U.S. and foreign tax purposes but that are taken into account at different times. We believe that it would be extremely difficult to adopt a general rule that would achieve appropriate results in all such cases.

It is also unclear that such a broad rule would be desirable even if it could be articulated. The United States has long accepted a certain amount of “hybridity” or tax arbitrage as the natural consequence of different policy choices made over time by different taxing jurisdictions. The foreign tax credit area is no different in this regard. For example, section 304 treats as a credit-bearing dividend certain sale proceeds that are in many cases exempt from foreign taxation. Taxpayers have routinely used subpart F inclusions affirmatively to repatriate foreign tax credits without incurring incremental foreign taxes. Such transactions are of course different from abusive separation transactions that IRS and Treasury currently appear to be targeting, but they reflect a certain widespread acceptance that hybridity in the foreign tax credit area is not *per se* inappropriate.

If the Proposed Regulations, when finalized, do contain a hybrid payment rule of general application (rather than a rule targeting abusive transactions), we recommend that IRS and Treasury make the rule prospective, notwithstanding the effective date of January 1, 2007, identified in the Preamble. The Proposed Regulations do not contain any rule that could be finalized retroactively, pursuant to section 7805(b)(1)(B), nor do they “substantially describ[e] the expected contents” of those final regulations, consistent with section 7805(b)(1)(C).

For instance, the IRS and Treasury ultimately could choose to apply the general approach of the Proposed Regulations to disregarded payments and respect them for purposes of allocating

⁵⁰ See generally Reg. § 1.6011-4(b)(2) (requiring the reporting of listed transactions).

the U.S. foreign tax credit because they are respected for foreign tax purposes. If so, then the payment would have the effect of shifting the credit to the recipient that includes the associated income under foreign law. That would be result under the general rule of the Proposed Regulations, if those regulations do not provide a special rule for hybrid payments. By contrast, if the IRS and Treasury were to adopt the opposite approach and disregard the payment for foreign tax credit allocation purposes on the ground that U.S. tax law gives it no effect, then the potential credit could continue to reside with the payor, depending on the characteristics of the hybrid instrument and on who foreign law sees as owning the tax base. In our view, the IRS and Treasury should not provide in final regulations—retroactively—the first indication of the government’s view regarding which of these diametrically opposed results is correct.

VI. Additional Comments

The Preamble contains a general request for comments. This section responds to this request by asking for clarification of certain issues implicated by the Proposed Regulations.

A. Computation of Income on a “Combined Basis”

Section 1.901-2(f)(2)(ii) of the Proposed Regulations states that “foreign tax is imposed on the combined income of two or more persons if such persons compute their taxable income on a combined basis under foreign law.” The Proposed Regulations provide no examples illustrating when two taxpayers compute their income on a “combined basis.” In addition, use of the term “combined basis” to define the term “combined income” begs the question what the term “combined” means.

For instance, we believe that two otherwise unrelated participants in a contractual joint venture do not compute their income on a “combined basis” even though each receives a distributive share of the combined income of the joint venture, reflected perhaps on a separate foreign return of the joint venture. We also believe that the reallocation of income by a foreign taxing authority among related corporations would not cause them to compute their income on a combined basis under the Proposed Regulations, even though foreign law has reallocated income from one entity to another under foreign transfer pricing provisions. We assume that the combined income rule would not apply if foreign law provides an election to consolidate that the taxpayer chooses not to make.

We therefore request that the Proposed Regulations, when finalized, provide additional guidance regarding when a group of entities computes its income on a combined basis. Possible criteria could be the offsetting of income and losses or the determination of rate brackets on the basis of aggregate income. We also request that the IRS and Treasury clarify that the exclusions from combined-basis reporting (*e.g.*, foreign integration and anti-deferral regimes) are disregarded only in the context of determining whether the foreign system computes income on a combined basis—and not in the context of determining the allocation of income once it has been determined that a foreign system computes income on a combined basis.

B. Transition Issues

The Proposed Regulations would generally apply to foreign taxes paid or accrued during taxable years beginning on or after January 1, 2007. However, the current IRS position appears to be that the Combined Income Rule already applies under the current regulations. The Proposed Regulations do not directly state whether the Combined Income Rule “clarifies” existing law or “updates” (and thus modifies) existing law. In light of the many significant modifications to the current regulations, including the removal of the joint-and-several-liability rule, we believe that the Proposed Regulations, when finalized, should apply prospectively to tax years beginning on or after January 1, 2007.⁵¹

The Proposed Regulations, when finalized, also should clarify the treatment of foreign tax credit carryovers from tax years beginning before January 1, 2007. A taxpayer may claim a credit for foreign taxes that were paid or deemed paid in a prior year, but were not credited due to the section 904 limitation. If the Proposed Regulations, when finalized, change the person who is considered the taxpayer with respect to a particular tax, it is unclear what happens to the carryover. It could be creditable by the person who would have been considered the taxpayer under the approach of the Proposed Regulations had they applied retroactively. In our view, that approach could lead to potential whipsaws because two taxpayers could claim the same credits without being consistent with each other. In this situation, it is also unclear whether the carryover would disappear if the taxpayer under the Proposed Regulations ceased to exist in the interim. Alternatively, the excess credit could remain potentially creditable by the person who was considered the taxpayer under the prior regulations, notwithstanding that person would not be considered the taxpayer if the tax were paid or accrued in the carryover year.

On balance, we believe that the IRS and Treasury should adopt the administratively simpler approach of leaving any excess credits with the taxpayer that generated them under the 1983 Regulations, rather than requiring retroactive adjustments to tax pools and amended returns to reflect the approach of the Proposed Regulations. In this respect, we believe that the Proposed Regulations, when finalized, should apply prospectively, even with respect to foreign consolidation systems otherwise subject to the Combined Income Rule.

Similarly, we believe that taxes paid or accrued in the first post-2006 year and carried back to the last pre-2007 year should be treated in the carryback year as paid or accrued by the same taxpayer. We thus do not believe that a foreign tax that would be treated as paid by a shareholder of a foreign corporation, or by a different foreign corporation, under the final regulations should be removed from a foreign corporation’s tax pool or moved to the tax pool of a different entity under the final regulations for carryback purposes. The rule we propose would be administratively simpler and allow taxpayers and the IRS to rely consistently on a single set

⁵¹ The Federal Circuit Court of Appeals decision in the *Guardian* case specifically notes that the current Regulations do not contemplate an inquiry into which party earns the income under foreign law. The Court goes on to state that it is well within the government’s power to change the regulations to achieve the result the government advocated in its arguments before the Court. Given the articulation of this view by the Federal Circuit, we are concerned that the government may open the regulations to challenge if the regulations were to be applied to periods prior to January 1, 2007.

of rules to determine which person should be treated as having paid a foreign tax that was paid or accrued in a foreign tax year ending prior to the effective date of the regulations.

The Proposed Regulations do not discuss whether taxpayers can apply them retroactively. If the IRS and Treasury were to permit taxpayers to apply the Proposed Regulations retroactively, when finalized, taxpayers should not be permitted to take inconsistent positions with respect to the incidence of the foreign tax. A duty of consistency should be imposed on related parties, or parties who were related at the time the foreign tax was imposed. If parties who were related but are now unrelated cannot agree on an election to apply the regulations retroactively, no election should be permitted.

C. Hybrid Partnerships

The Proposed Regulations provide guidance regarding foreign taxes that are imposed on a hybrid partnership, an entity treated as a partnership under U.S. law and a taxable entity under foreign law. The Proposed Regulations confirm existing law regarding the person that is treated as legally liable for a foreign tax and introduce certain allocation rules for situations where there are changes in the ownership of the hybrid partnership.

The Proposed Regulations reaffirm existing law by providing that in the case of an entity-level income tax imposed on a hybrid partnership, the hybrid partnership is considered to be legally liable for the tax under foreign law.⁵² The Proposed Regulations then direct the taxpayer to the section 704 temporary regulations for purposes of allocating those taxes among the partners of the hybrid partnership.⁵³ Interestingly, the Preamble provides that “[t]his is the case even if the owners of the entity also have a secondary obligation to pay the tax,” but similar language is not included in the regulation text. We recommend that the IRS and Treasury incorporate this language into the text of the regulation itself when the regulations are finalized.

The Proposed Regulations also provide allocation rules that apply to situations where a hybrid entity undergoes a change in ownership that affects its U.S. income taxable year, but does not affect its foreign taxable year. Such situations potentially can cause the separation of foreign taxes and related income in a manner similar to the sale of a bond between coupon dates. The source of the problem is that income typically accrues over the course of a taxable year, but foreign income taxes generally accrue all at once, at the close of the foreign taxable year.⁵⁴

The Proposed Regulations address the consequences of a termination of a hybrid partnership’s U.S. taxable year, either for all partners in the case of a section 708 termination, or with respect to one of the partners under section 706.⁵⁵ The Proposed Regulations also cover situations where there is a change of a partner’s interest during the course of a taxable year.⁵⁶ In

⁵² Prop. Reg. § 1.901-2(f)(3)(i).

⁵³ We note that the cross-references in Prop. Reg. § 1.901-2(f)(3)(i) and (ii) to Reg. § 1.704-1(b)(4)(viii) presumably should be to Reg. § 1.704-1T(b)(4)(xi).

⁵⁴ See Rev. Rul. 61-93, 1963-1 C.B. 390; Rev. Rul. 75-532, 1975-2 C.B. 295.

⁵⁵ Prop. Reg. § 1.901-2(f)(3)(i).

⁵⁶ *Id.*

both of these situations, the Proposed Regulations allocate the foreign taxes under the principles of section 1.1502-76(b) of the Regulations.

We recommend that the Proposed Regulations, when finalized, apply a different approach for each of these sections to avoid any potential mismatching in the allocation of taxes. In the case of a section 708 termination, income generally is divided between the two short taxable years based on a closing of the books at the time of the deemed termination. In the case of a taxable year that closes with respect to one (but not all) partners under section 706, the partnership can elect either to spread tax items ratably between the two periods or to use a closing of the books. Accordingly, the difference in the approaches between the two methods for allocating the income and taxes presents the possibility of separating income and taxes in a manner that the regulations were intended to prevent. We recommend that the Proposed Regulations, when finalized, allocate the foreign taxes to the two periods based on the allocation of the related foreign income. In other words, the income of the partnership should be allocated to the period before or after the section 706 or 708 event under those respective rules, and then the foreign taxes should be allocated between the two periods by determining the foreign taxes that relate to the separate portions of foreign income.⁵⁷

Additionally, the Proposed Regulations do not apply their allocation rules to section 708 terminations that arise under section 708(b)(1)(A) in the case of a partnership that has ceased its operations. We recommend extending the Proposed Regulations to cover these situations as well. Consider the following example:

H, an entity formed under the laws of Country X, has a calendar taxable year for both U.S. and Country X tax purposes. H is taxed as a corporation in Country X, but is treated as a partnership for U.S. tax purposes. X is owned 40 percent by A, and 60 percent by B. On March 31, A sells its entire interest to C. On June 30, H ceases all operations and under section 708(b)(1)(A), its U.S. taxable year terminates. For Country X purposes, however, its taxable year remains open until December 31. On December 31, H's foreign taxable year closes, and it owes \$100 in foreign tax, all of which is attributable to income it earned prior to March 31.

Under the current Proposed Regulations, it does not appear A would be allocated any of the \$100 of foreign taxes because they accrue in a U.S. taxable year during which A is not a partner of H. We believe that A should be allocated these taxes because they relate to income which A was required to include.

D. Use of Disregarded Entities and Hybrid Partnerships to Allocate Credits

In Example 4 of the Proposed Regulations,⁵⁸ A purchases a bond issued by X, a foreign person. A accrues interest income on the bond from January 1, 2007 until July 1, 2007, when A sells the bond to B. On December 31, 2007, X pays to B the interest that accrued during the

⁵⁷ Cf. Reg. § 1.338-9(d) (allocating foreign taxes between old target and new target in a section 338 transaction).

⁵⁸ Prop. Reg. § 1.901-2(f)(6) (Example 4).

entire year. The interest payment is subject to foreign withholding tax. This withholding tax is imposed on the recipient under foreign law. The Proposed Regulations allocate the entire withholding tax to B, and none to A, even though A is required to include in income half of the accrued interest for 2007, based upon A's ownership of the bond from January 1 to July 1.

This example implies that the Proposed Regulations accept that the separation of income and credit might arise in certain cases. We note, however, that the proposed rules for disregarded entities and hybrid partnerships allow a certain degree of electivity for taxpayers facing A's predicament in Example 4.

Instead of holding the bond directly, A on January 1 could have contributed the bond to a disregarded entity or a hybrid partnership and sold its interest in the entity to B. If A had done so, then the Proposed Regulations would appear to allocate the foreign withholding tax between A and B, rather than entirely to B. The Proposed Regulations would allocate the tax between the respective portions of the taxable income of the partnership or disregarded entity attributable to the period ending on and the period ending after the sale transaction.⁵⁹ Using a pass-through investment vehicle thus appears to allow A and B to negotiate between a full allocation of the credit to B and a partial allocation of the credit to A—subject, however, to the transaction costs of forming a disregarded entity or partnership.

In this respect, the Proposed Regulations appear to create a trap for the unwary, or an opportunity for the well-advised. Taxpayers can use self-help to allocate the credit between their ownership periods by choosing whether or not to transact through a pass-through entity. Ideally, the Proposed Regulations, when finalized, would not permit this type of electivity, but we agree with the implicit view of the Proposed Regulations that it would be administratively unworkable to require in every case a precise allocation of the credit based on income accrued on an actively traded security. We therefore recommend that the Proposed Regulations, when finalized, permit multiple owners of the same security to agree to allocate withholding taxes imposed on income generated by the security in proportion to the income each owner accrued on the security. Permitting this type of allocation would not afford taxpayers a benefit greater than that which the Proposed Regulations already provide. It simply would reduce transaction costs and eliminate a potential tax trap.

E. Collateral Consequences

Section 1.901-2(f)(2)(v) of the Proposed Regulations provides that U.S. tax principles determine the tax consequences if one person remits a tax that is treated as the legal liability of, and considered paid by, another person (following allocation of the foreign tax). Under this provision, a Partner in a reverse hybrid that pays a tax deemed to be owed by the reverse hybrid is treated as making a capital contribution to the reverse hybrid, which is viewed as paying the tax with the proceeds.⁶⁰ The Proposed Regulations imply, but do not specify, that appropriate adjustments to the reverse hybrid's earnings and profits and stock basis also should be made to give effect to the collateral consequences. We request that IRS and Treasury clarify those adjustments in the final regulations.

⁵⁹ See Prop. Reg. § 1.901-2(f)(3).

⁶⁰ See, e.g., Prop. Reg. § 1.901-2(f)(6) (Example 7).

The Proposed Regulations leave unclear whether the direct payment by the reverse hybrid to the foreign taxing authority of the foreign tax imposed under foreign law on its Partner gives rise to a deemed distribution from the reverse hybrid to the Partner under U.S. law. In our view, it should not. The reverse hybrid should be able to pay the foreign tax that the Proposed Regulations effectively allocate to it without creating a deemed dividend to the Partner.

The payment of the Partner's tax by the reverse hybrid does not give rise to a tax benefit recognized by U.S. tax law. The reverse hybrid has indeed satisfied a legal liability of the Partner under foreign law, but the Proposed Regulations would not recognize that liability as a liability of the Partner. The Proposed Regulations specifically allocate it away from the Partner and to the reverse hybrid. Thus, the only "benefit" created by a direct payment of the reverse hybrid's tax arises due to the operation of the foreign tax system. In the context of group relief payments, the IRS has long taken the position that such benefits are meaningless.⁶¹

If the reverse hybrid's tax payment were treated as a deemed distribution to the Partner, moreover, the Partner presumably would be treated as re-contributing the proceeds of the deemed distribution to the reverse hybrid, which then pays the tax. As a result, the Partner would take into income the deemed distribution, increase its earnings and profits, and receive a stepped-up basis in its interest in the reverse hybrid, although in reality no transfer of funds occurred between the two entities. We recommend that the final regulations specifically preclude this type of recharacterization.

While the Proposed Regulations do not directly address the payment by the reverse hybrid of the foreign tax, they do indicate that an economically identical transaction—the payment by the Partner of the foreign tax, followed by the reimbursement of that payment by the reverse hybrid—*will* be treated as a distribution by the reverse hybrid.⁶² We recommend that the IRS and Treasury reconsider this rule. We believe that the more appropriate U.S. tax treatment of the Partner in such cases is that of a mere paying agent, acting on behalf of the reverse hybrid. The order in which the payment to the foreign taxing authority is made should not determine the U.S. tax treatment. The reimbursement of the tax payment by the reverse hybrid should not give rise to a deemed distribution to the Partner.

F. Interaction with Tax Treaties

The U.S. treatment of foreign taxes from different countries may differ among foreign countries based on the provisions of bilateral income tax treaties between the United States and each of those countries. Certain tax treaties, for example, provide additional procedural and substantive protections against the double taxation of income. If Regulations under section 901 serve to allocate legal liability for such foreign taxes from an entity resident in one treaty

⁶¹ See, e.g., G.C.M. 39,367 (June 3, 1985) (reasoning that U.S. tax law rejects "the notion that the tax benefits attributable to the filing of a consolidated return, whether resulting from the ability to offset the losses of one member of the group against the income of another or for other reasons, represent value transferred to the benefiting members of the group by other members.").

⁶² See Prop. Reg. § 1.901-2(f)(2)(v).

jurisdiction to an entity resident in another treaty jurisdiction, it is unclear which set of treaty provisions would apply to those foreign taxes. Consider the following example:

USP, a domestic corporation, owns FC, a foreign corporation resident in Country A, which in turn owns DE, a disregarded entity resident in Country B. A and B treat DE as a corporation. Under certain U.S. income tax treaties, taxes imposed on the income of DE would be covered, if at all, by the U.S.-Country B treaty, not the U.S.-Country A treaty, as DE would be considered a resident of country B under the treaty and subject to country B taxation on its profits. Furthermore, DE would not be entitled to treaty benefits under the Country A treaty even though DE is disregarded for U.S. tax purposes, as its income is not subject to tax in Country A, which views it as a non-resident corporation.

In this fact pattern, the Proposed Regulations would treat FC as legally liable for the Country B taxes imposed on DE, but it is unclear whether the creditability of the foreign tax would be governed by the U.S.-Country A treaty, the U.S.-Country B treaty, or neither treaty. We believe that the Proposed Regulations, when finalized, should clarify the nature of their interaction with U.S. tax treaties.

In our view, applicable treaty provisions generally should take precedence over the Proposed Regulations, in accordance with section 894. In the foregoing example, we believe that the U.S.-Country B treaty should continue to govern the creditability of the Country B taxes, and that the regulations should explicitly provide for such treaty application. This treatment is consistent with the Proposed Regulations' general approach of looking to the person who is required to take the income into account for local law purposes and who is liable for such taxes under such law. This rule makes practical sense in our view because the competent authority of Country A would be unlikely to accept jurisdiction over a mutual agreement procedure involving the Country B tax.

G. Rate Differentials

The Combined Income Rule, as applied to reverse hybrids, allocates foreign taxes between the reverse hybrid and its Partner or Partners based on the relative amounts of income the Partner earns through the hybrid and directly from the foreign country.⁶³ The Proposed Regulations do not appear to distinguish between potential differences in rates of tax imposed on income received directly and income received through the reverse hybrid. The income received directly may be subject to a gross basis withholding tax, or it may be eliminated entirely pursuant to an applicable income tax treaty. Depending on how the allocation methodology of the Proposed Regulations works, the mixing of direct and indirect income streams could result in a distorted allocation of taxes between the reverse hybrid and the Partner.

For instance, assume that a Partner earns \$100 of interest income and \$100 of operating income through the reverse hybrid. The Partner qualifies for the benefits of an applicable

⁶³ See Prop. Reg. § 1.901-2(f)(2)(iii).

income tax treaty, pursuant to which the interest income is exempt from foreign tax. In contrast, the income earned through the reverse hybrid is subject to a 30 percent foreign income tax. The combined income of \$200 is allocated \$100 to the Partner and \$100 to the reverse hybrid. Consequently, the \$30 of tax on the combined income is allocated equally between the Partner and the reverse hybrid (\$15 each). Although in fact the foreign tax was imposed entirely on the operating income, the Combined Income Rule treats the Partner as liable for half the taxes in respect of its interest income.

We request that the IRS and Treasury provide guidance, including one or more examples, regarding the application of the Combined Income Rule to reverse hybrids and other groups where income of different group members, or different types of income, are subject to significantly different tax rates.

H. Ordering Rules

The Proposed Regulations do not indicate in which order the various rules for reverse hybrids, disregarded entities, and hybrid partnerships apply. The Proposed Regulations also offer no specific guidance whether taxes allocated to an entity under one rule are then susceptible to further allocation under a different rule. Consider the following example:

USP, a domestic corporation, owns FS, a Country A corporation. FS owns an interest in FRH, a Country A reverse hybrid. FRH owns all the interest in FDE, a Country B disregarded entity. FS earns \$10 directly from Country A and \$20 as a distributive share of Country A income from FRH. FS pays \$6 of Country A tax on its \$30 of income. For U.S. tax purposes, FRH also earns \$10 from Country B through FDE, subject to Country B tax of \$3. FDE makes no actual cash distribution to FRH during the year.

The Proposed Regulations allocate the income (\$10) and associated Country B taxes (\$3) of FDE to FRH because FRH owns the assets of FDE for U.S. tax purposes. The Proposed Regulations also allocate between FS and FRH the Country A tax imposed on FS's income, based on the ratio of FS's direct Country A income to FS's total Country A income ($\$10 \div \30 , or $1/3$). It is unclear from the Proposed Regulations, however, whether a portion of the Country B tax allocated to FRH under the disregarded entity rule is then allocated to FS based on that same ratio (an additional \$1 of tax, based on $1/3$ of a Country B tax of \$3). If Country A treats FDE as a separate juridical entity, its income will not be included in the base that the Proposed Regulations use to allocate income and taxes between FS and FRH. Thus, if the rules apply concurrently, then FS could attract a disproportionately large (or small) amount of foreign tax.

We request that the IRS and Treasury include additional examples illustrating their application in the case of tiered structures, such as the one described above, as well as the opposite structure, in which a disregarded entity (or hybrid partnership) owns a reverse hybrid.