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April 4, 2005

Mr. Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)
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Room 3104 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Acting Deputy Assistant Secretary Solomon and Commissioner Everson:

I am pleased to submit the New York State Bar Association Tax Section's Report No. 1083, which outlines a possible approach to revising and broadening regulation section 1.901-2(f)(3) (which deals with the allocation of foreign taxes among related foreign persons) to limit the potential for inappropriate separations of foreign tax from related foreign income. The proposed revisions would be on a prospective basis only.

The Report responds to an announcement by the Treasury Department and the Internal Revenue Service that they are considering possible revisions to regulation section 1.901-2(f)(3). The Report is also germane to the Administration's recent request for regulatory authority to deal with inappropriate separations of foreign tax from related foreign income. The Joint Committee discussion of this request cites as an example of the potential problem a foreign partnership that is treated as a corporation solely for U.S. tax purposes with the result that foreign tax is imposed on its U.S. partners but the income remains behind in the foreign "corporation" for U.S. tax purposes.

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The Report's recommendation would not involve a wholesale reconsideration or abandonment of the "technical taxpayer rule," as set forth in section 1.901-2(f)(1), with the attendant complexities of developing a substitute rule for determining who is eligible to claim a foreign tax credit. Thus, the benefits of simplicity, certainty and administrability afforded by the technical taxpayer rule would be preserved in the many situations that did not involve structures that are designed to separate creditable foreign tax from the related tax base.

Regulation section 1.901-2(f)(3) currently provides that where a foreign tax is imposed on the combined income of related persons that are jointly and severally liable for such tax, "foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of tax, regardless of which person actually pays the tax." The key components of our recommendation are (a) to eliminate the "joint and several" limitation on the operation of this rule, (b) to expand the relevant definitions of "combined income" and "related person" (so that a related person includes, for example, a U.S. person upon whom foreign tax is directly imposed on account of income earned by one of its reverse-hybrid foreign subsidiaries), and (c) to provide that the portion of the foreign tax base attributable to each related person is determined under U.S., rather than foreign, tax principles.

In our view, Treasury and the IRS do not need a further grant of regulatory authority to implement the amendments recommended in the Report. Specifically, we believe that affirmative authority for amending the regulation to address the separation between creditable foreign taxes and the related tax base in the situations covered in the report exists under sections 482 and 7805. Moreover, we believe that Treasury and the IRS would not be limited or prevented from amending the regulation as proposed in the Report by the *Biddle* case, the long-standing practice under the technical taxpayer rule or Congress' failure last year to grant the expanded authority that Treasury and the IRS requested under the foreign tax credit rules. The Report sets out our position on these matters.

We appreciate your consideration of our proposals and the issues we have addressed in the Report. As always, we would be pleased to discuss these matters with you further or provide any other assistance that you would find helpful.

Respectfully submitted,

David P. Hariton
Chair

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Regulation Section 1.901-2(f)(3) and the Allocation of Foreign Taxes Among Related Persons

April 4, 2005

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Report No. 1083

New York State Bar Association Tax Section

Report on Regulation Section 1.901-2(f)(3) and the Allocation of Foreign Taxes Among Related Persons

I. INTRODUCTION.

This report[1] discusses issues pertinent to the regulation project that has been announced by the Treasury Department and the Internal Revenue Service (the "IRS") to consider possible revisions to Treasury regulation section 1.901-2(f)(3),[2] which in general deals with the allocation of foreign income taxes that are imposed on the combined income of related persons that are jointly and severally liable for such taxes.

Attention has recently been drawn to this provision as some taxpayers have taken advantage of certain foreign consolidated tax regimes (in particular, in Australia and Luxembourg), reverse hybrid (and/or hybrid) entities, or no-current-coupon hybrid securities, to claim a credit for foreign income taxes while not including in income the tax base to which such taxes relate. For example, a U.S. corporation might organize the operating subsidiaries of a group of French companies that file a French consolidated tax return as tax-transparent entities for French tax purposes but as corporations for U.S. tax purposes (*i.e.,* reverse hybrid entities), so

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1 This report was drafted by Yaron Z. Reich on behalf of an *ad hoc* committee consisting of Peter Blessing, Patrick J. Brown, Julio Castro, Andrew Chalnick, Joseph J. Czajkowski, Kevin Glenn, David Hardy, David P. Hariton, Marc M. Levey, Douglas R. McFadyen, John Narducci, Brian Sheehan, Andrew P. Solomon and Marc D. Teitelbaum, not all of whom support the report's conclusions and recommendations. Helpful comments were provided by Kimberly S. Blanchard, Peter Connors, Stephen Land, David S. Miller, James M. Peaslee, Michael L. Schler and Willard B. Taylor.

2 All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury regulations promulgated thereunder.

The Treasury Department and IRS' 2004-2005 Priority Guidance Plan describes the regulation project more broadly as "Regulations on the allocation of foreign taxes," without referring specifically to section 1.901-2(f)(3).

that the French tax liability of the subsidiaries is imposed on the parent of the French group but the related income is considered for U.S. tax purposes to be earned by the subsidiaries.

These taxpayers have relied on the so-called "technical taxpayer rule" of section 1.901-2(f)(1) – under which the "person on whom foreign law imposes legal liability" for a tax is entitled to claim the credit – as well as other precedent articulating that rule, and in certain circumstances also on their reading of section 1.901-2(f)(3) (discussed below), to conclude that because, under the relevant circumstances, only the parent entity of the group of foreign entities is liable for the foreign income tax on the income of the group, its payment of the tax is eligible to be claimed as a credit under section 901 (if the parent entity is a hybrid whose sole member is a U.S. corporation) or under section 902 (in other cases), even though the income that is subject to the foreign tax was earned (under U.S. tax principles) by other members of the foreign group and is not currently includible in income by the taxpayer. The IRS has challenged this interpretation of the law in a pending case, *Guardian Industries Corp. v. United States*.[3] Additionally, the IRS has opened a regulation project to consider possible changes to the applicable regulations.

This report outlines possible approaches to revising the regulations and discusses the regulatory authority and policy considerations relating thereto. Part II sets forth our conclusions and recommendations. Part III reviews current law and recent developments, while Part IV describes various situations in which a creditable foreign tax can be separated from the related tax base. Part V explores policy considerations relevant to whether and, if so, how to modify the existing regulations, and Part VI considers issues relating to the regulatory authority

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[3] Ct. of Federal Claims, No. 02-1936 T.

for changes that might be implemented. Part VII discusses our recommended approach and possible alternatives for modifying the regulations. Finally, Part VIII discusses transition rules.

For the avoidance of doubt, we emphasize at the outset that this report only addresses possible prospective changes to the regulations and does not (and should not in any way be construed to) express a view on current law or its application to any pending case or other factual situation.

II. CONCLUSIONS AND RECOMMENDATIONS.

For the reasons discussed below, we believe that it is appropriate and desirable as a policy matter for the Treasury Department and the IRS to amend the regulations to limit the potential for separation within related entities of creditable foreign taxes from the tax base to which they relate. We believe that such an amendment can be effected within the context of the technical taxpayer rule, so that the benefits of simplicity, certainty and administrability afforded by that rule can be preserved in the many situations that do not involve structures that are designed to separate creditable foreign tax from the related tax base. We also are of the view that Treasury and the IRS have regulatory authority to implement the amendments recommended herein.[4]

In line with the foregoing, we recommend that section 1.901-2(f)(3) be amended so as to expand its scope. Section 1.901-2(f)(3) now provides that,

> If foreign income tax is imposed on the combined income of two or more related persons (for example, a husband and wife or a corporation and one or more of its subsidiaries) and they are jointly and severally liable for the income tax under foreign law, foreign law is considered to impose legal liability on each such

[4] Because we believe that the approach recommended herein adequately addresses the problem situations within the existing regulatory framework, we have not considered in this report the more fundamental and far-reaching questions of whether it would be desirable to replace the technical taxpayer rule, what an alternative system might provide, whether any such alternative system might better serve the policies underlying the foreign tax credit rules and resolve other imperfections in their application, and the regulatory authority for implementing any such alternative system.

person for the amount of the foreign income tax that is attributable to its portion of the base of the tax, regardless of which person actually pays the tax.

We have considered several possible approaches for expanding the regulation, including modest revisions that would cover only situations in which the separation of creditable foreign tax from the related tax base occurs pursuant to foreign consolidated tax regimes but would not cover situations in which the separation is effected solely through the use of reverse hybrid (and, in some cases, hybrid) entities. We have concluded, however, that such a narrow approach is not desirable because structures using a hybrid or reverse hybrid entity as the parent company of a group of foreign entities (and/or as a member of such a group) can be set up virtually anywhere in the world so as to enable a U.S. taxpayer to claim foreign tax credits without including in income the related tax base, and therefore are more troublesome than the consolidated tax regimes of some countries. As discussed below, similar concerns are presented by certain structures that use no-current-coupon hybrid securities and other hybrid arrangements, and therefore we recommend that the proposed changes set forth below should generally apply to such structures as well (which would be the case under the formulation of these proposals set forth below).

Therefore, we recommend that section 1.901-2(f)(3) be amended by:

a. Removing the "joint and several" condition;

b. Providing that "a foreign income tax is imposed on the combined income of two or more related persons" (A) whenever the tax base on which the foreign income tax is imposed includes, at least in part, income of two or more (U.S. or foreign) related persons, regardless of whether that is true for U.S. or foreign tax purposes (or includes an amount that is income of one related person for U.S. tax purposes but is income of another for foreign tax purposes), and (B) even if the relevant tax base of one or more of such related persons is limited to income that is connected with the foreign tax jurisdiction rather than worldwide income, but (C) generally not if the tax is imposed under (i) an integrated tax system (*e.g.*, where, for purposes of computing its own tax liability, the owner of an interest in a person is eligible for a credit in respect of its share of the taxes paid by,

or an exclusion in respect of its share of the income of, such person) or (ii) a group relief system such as in the U.K. (where each company computes its liability on a stand-alone basis but companies within the group can surrender losses to affiliates);[5]

c. Providing that for this purpose, a "person" includes a tax-transparent entity, whether under U.S. or foreign law;

d. Providing that the requirement that the persons be "related" be interpreted broadly to cover any definition of relatedness under the applicable foreign law as well as a transparent entity and its members (with respect to such member's share of the tax base of the transparent entity);

e. Providing that the "portion of the base of the tax" that belongs to each such person is to be determined under U.S. tax principles in a manner consistent with the principles underlying the foreign tax credit rules, so that if an amount is treated as income of one related person for U.S. tax purposes but as income of another for foreign tax purposes, "foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of the tax" as determined for U.S. tax purposes in a manner consistent with the principles underlying the foreign tax credit rules; and

f. Clarifying that where the taxpayer is a partnership for U.S. federal income tax purposes, temporary regulation section 1.704-1T(b)(4)(xi) (dealing with the allocation of foreign tax credits among partners) should apply after section 1.901-2(f)(3).

In terms of transition rules, we recommend that the proposed amendments should apply prospectively, as of the beginning of the first taxable year of the relevant foreign entity after their effective date. Taxes that were taken into account under sections 901 or 902 during a previous taxable year should be disregarded for purposes of post-effective date taxable years.

We note that structures that separate creditable foreign tax from the related tax base can exist both where all of the relevant entities are taxpayers in the same foreign country and in cross-border situations involving more than one foreign country. The cross-border situations can arise as a result of the use of reverse hybrid entities or no-current-coupon hybrid

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[5] The exceptions for integrated and group relief tax systems would not apply to the extent a separation between creditable taxes and the related tax base occurs as a result of a reverse hybrid structure or no-current-coupon hybrid security (or other hybrid arrangement).

securities, or as a result of foreign CFC-type regimes. It appears that, in general, certain cross-border situations raise the same concerns as reverse hybrid structures or no-current-coupon hybrid securities in a single foreign country, while other cross-border situations do not necessarily raise such concerns. Nonetheless, on balance we recommend that the proposed changes should apply without exception to all cross-border situations.

Finally, we recognize that the separation of creditable foreign tax from the related tax base may arise in other contexts and as a result of other techniques than those addressed in this report. Each of those situations should be evaluated on its own to determine whether the separation is consistent with the policies underlying the foreign tax credit and, if not, whether a remedy can be implemented in an efficacious manner under existing regulatory authority. The failure at this time to address every single imperfection in the foreign tax credit rules, however, should not in our view dissuade the IRS from modifying section 1.901-2(f)(3) as discussed herein.

III. REVIEW OF CURRENT LAW AND RECENT DEVELOPMENTS.

A. The Regulation and its Antecedents.

As indicated above, the technical taxpayer rule is embodied in section 1.901-2(f)(1), which provides that, "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, even if another person (e.g., a withholding agent) remits such tax."[6] Section 1.901-2(f)(2) elaborates on this pronouncement by stating that, "Tax is considered paid by the taxpayer even if another

[6] Proposed on April 5, 1983 (48 Fed. Reg. 14641) and adopted on October 6, 1983 by T.D. 7918. The current regulation replaced temporary regulations to the same effect, issued in 1980. Prior to 1980, the regulations provided a credit for "taxes proper, paid or accrued during the taxable year on behalf of the taxpayer claiming the credit." Section 1.901-2(a) (1979).

party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability." For example, if a foreign country imposes a withholding tax on interest income earned by a U.S. lender and the borrower agrees to "gross up" its interest payments so that the U.S. lender is made whole for such tax, the U.S. lender nonetheless is entitled to claim a foreign tax credit for the full amount of the withholding tax.[7]

It is very clear, therefore, that eligibility to claim a foreign tax credit turns on legal liability for the tax under foreign law rather than actually bearing the economic burden of the tax. It is generally understood that the policy rationale behind this "technical taxpayer" rule is the desire to have a simple, straightforward rule that can be readily administered by taxpayers and the IRS and that avoids the difficult and often nebulous inquiries as to where the incidence of tax falls as an economic matter.

Section 1.901-2(f)(3) provides guidance for situations where more than one person is liable for the income tax under foreign law – *i.e.,* where the foreign tax is imposed on the combined income of two or more related persons and they are jointly and severally liable for the tax. In such a situation, "foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of the tax, regardless of which person actually pays the tax."

The derivation and application of the foregoing provisions can be appreciated through a brief review of several of the leading cases and revenue rulings that predate the regulations.

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[7] *Cf. Continental Illinois Corp. v. Commissioner*, 988 F.2d 513, 516 (7th Cir. 1993) (describing change in IRS position to accept creditability of withholding tax where loan has a "gross up" clause).

Biddle v. Commissioner[8] involved the U.K. integrated tax regime, under which a shareholder who received a dividend from a U.K. corporation took into account as income for U.K. tax purposes, and claimed a credit against its U.K. tax liability for, the portion of the U.K. corporate tax paid in respect of the dividend. Depending on the circumstances, the shareholder could claim a refund of the corporate level tax (if the shareholder was exempt from tax) or may owe a surtax. The Supreme Court held that a U.S. shareholder was not entitled to claim a direct foreign tax credit under the predecessor of section 901 because "our statutes . . . have never treated the stockholder for any purpose as paying the tax collected from the corporation. Nor have they treated as taxpayers those upon whom no legal duty to pay the tax is laid."[9] In arriving at this conclusion, the Supreme Court held that while it is appropriate to look to foreign law to ascertain the relevant facts regarding liability for the foreign tax, the determination of which person has "paid" a foreign tax is made based on U.S. tax principles.[10] The Supreme Court also held that it was irrelevant that the shareholder bore the economic burden of the foreign tax.[11] *Biddle* is generally considered the leading case articulating the technical taxpayer rule.

In *Abbot Laboratories International Company v. United States,*[12] a U.S. corporation claimed a direct foreign tax credit in respect of Argentine and Colombian income taxes that were paid by its 95% owned Argentine and Colombian subsidiaries, respectively. Each of these subsidiaries was organized as a sociedad responsibilidad de limitada (or SRL), and qualified as a reverse hybrid entity – *i.e.,* it was a corporation for U.S. federal income tax purposes but a partnership for Argentine and Colombian tax purposes. Despite the parties'

8 302 U.S. 573 (1938).

9 302 U.S. at 581.

10 302 U.S. at 578 – 579.

11 302 U.S. at 580 – 581.

12 160 F. Supp. 325 (No. Dist. Ill., 1958), *aff'd per curiam*, 267 F. 2d 940 (7th Cir. 1959).

stipulation that the taxpayer was primarily liable under Argentine and Colombian law for payment of the respective SRL's taxes, the court denied a direct foreign tax credit. The court reasoned that taxpayer could not claim a direct credit because (i) the SRLs were ultimately responsible under foreign law if the tax were not paid, (ii) applying U.S. tax concepts, as the court understood was appropriate under *Biddle*, the SRLs were corporations, and the taxpayer so regarded them when it did not report its distributive share of their profits, so the tax should be considered to have been paid by the corporations, (iii) the taxpayer's ability to credit the SRLs' taxes was preserved through the indirect foreign tax credit and (iv) it is inconsistent with the purpose of the foreign tax credit (*i.e.,* to avoid double taxation) to allow a "select group of taxpayers . . . to postpone the time for the realization of foreign income indefinitely, while at the same time using the foreign tax paid on such income, to lessen their tax burden in this country."[13]

In view of the court's finding that the SRLs were ultimately responsible under foreign law if the tax was not paid, the remainder of the *Abbot Laboratories* opinion may be considered dicta. Still, the court clearly was unwilling to interpret the technical taxpayer rule of *Biddle* as sanctioning a taxpayer's separating creditable foreign taxes from the tax base to which they relate. It is fair to say, however, that the IRS was not troubled by that possibility, as evidenced by its subsequent rulings.

Revenue Ruling 58-518[14] involved a domestic corporation, M, which owned all of domestic corporation N and foreign corporation O. Foreign country taxed the income of O and royalty income received by N from O, and in addition imposed a tax on M in respect of the combined income of N and O but reduced by a credit for the foreign country income taxes paid

[13] 160 F. Supp. at 328 - 329.

[14] 1958-2 C.B. 381.

by N and O. The IRS held, *inter alia,* that M may claim a direct foreign tax credit for the income taxes paid by it in respect of the combined income of N and O, stating that, "There is no authority in the law for prorating to the subsidiaries N and O, for the purpose of computing the allowance for income taxes paid to a foreign country, the foreign income taxes assessed against and borne by M."

In Revenue Ruling 72-197,[15] a domestic unincorporated association that was taxable as a corporation for federal income tax purposes, owned properties in a foreign country. The foreign country treated the association/corporation as a partnership and imposed tax on its owners (*i.e.,* the entity, like the SRLs in *Abbot Laboratories*, was a reverse hybrid entity). The IRS held that the owners, not the association/corporation, were entitled to claim a direct foreign tax credit. Although the ruling did not explicitly say so, it obviously accepted that the owners would not need to report the related income unless and until it was distributed to them.

In Revenue Ruling 77-209,[16] the IRS considered a "fiscal unity" foreign tax regime, which permitted a resident corporation and its subsidiaries to be taxed as if the subsidiaries were merged into the parent corporation. While the parent corporation paid the taxes of the fiscal unity group, each member was jointly and severally liable for the group's tax liability. The IRS distinguished Revenue Ruling 58-518 on the grounds that in the fiscal unity situation there was joint and several liability, and on that basis held that the tax should be prorated among each member of the group and treated as if each corporation actually paid the foreign tax allocated to it.

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[15] 1972-1 C.B. 215. Revenue Ruling 72-197 restated under current law, and superseded, the position first set forth in A.R.R. 643, C.B. 5, 230 (1921).

[16] 1977-1 C.B. 238.

The technical taxpayer rule in section 1.901-2(f)(1) reflects *Biddle* and Revenue Rulings 58-518 and 72-197, while section 1.901-2(f)(3) follows Revenue Ruling 77-209.

B. Withholding Taxes.

Withholding taxes on dividends, interest and other similar types of passive income contain facets that are similar to those presented by the situations that are the subject of this report. First, as noted above, the fact that a lender may claim a credit for withholding taxes even where the borrower agrees to "gross up" its interest payments for the withholding tax underscores the technical taxpayer rule's principle that eligibility to claim a foreign tax credit is not dependent on the taxpayer economically bearing the tax.

Second, cases involving Brazilian and U.K. withholding taxes on interest have consistently held that the U.S. lender is treated as the person who "paid" the withholding tax and had "legal liability" therefor because it earned the income, even though the foreign tax laws at issue in these cases imposed an obligation to pay the tax only on the borrower and did not contain any remedy against the U.S. lender.[17] While these cases could be considered departures from a strict application of the technical taxpayer rule, it would appear that they are consistent with *Biddle*'s admonition that U.S. tax principles should govern the determination of who "paid" the tax.[18]

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[17] *Norwest Corp. v. Commissioner*, 69 F.3d 1404 (8th Cir. 1995); *Continental Illinois Corp. v. Commissioner*, *supra; Nissho Iwai American Corp. v. Commissioner*, 89 T.C. 765 (1987); *Gleason Works v. Commissioner*, 58 T.C. 464 (1972).

[18] For example, the court in the *Continental Illinois* case stated:

> "Naturally, the Brazilian and American tax systems are not identical, but the differences between them with respect to withholding are too minor to justify a conclusion that Brazil is "really" taxing the borrower and not the lender. The essential similarity is that the tax is based on the income received by the lender. Such a tax is an income tax. Actually it is a gross-receipts tax rather than an income tax, because the cost of lending is not netted out of the interest received by the lender. But the IRS treats it as an income tax, and the correct characterization is not important to this case ..." *Continental Illinois, supra*, 988 F.2d at pp. 518-519 (citations omitted).

Third, withholding taxes also present an opportunity to separate creditable taxes from the tax base to which they relate. Withholding taxes are collected by the payor from its payment of interest, dividends, royalties, etc., but economically they relate to the income earned during the entire period over which such income accrued. Until recently, a taxpayer who purchased a bond or share of stock immediately before the relevant interest payment or dividend record date generally was eligible to claim a credit for the entire amount of the withholding tax on such interest or dividend payment even though as an economic matter it earned only a small portion of the income (corresponding to the short period prior to the interest or dividend payment during which it owned the bond or stock). This spawned some aggressive transactions and at least two decided cases in which the taxpayers prevailed.[19] Congress addressed the problem by enacting sections 901(k) and (l), which impose a minimum 16-day holding period in order to claim a foreign tax credit for withholding taxes.[20]

C. Recent Developments.

The IRS announced in Notice 98-5[21] that it would issue regulations designed to combat transactions that create the potential for foreign tax credit abuses. The notice targeted

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In that case and the other Brazilian withholding tax situations, the courts were influenced by the fact that, as a practical matter, the interest payment could not be made unless and until the Brazilian withholding tax was paid because proof of payment of the tax was a condition to obtaining the foreign currency to make the interest payment. *See, e.g., id.*, 988 F. 2d at p. 518; *Nissho Iwai American Corp. supra*, 89 T.C. at p. 769. No such factor was present in *Gleason Works*, where the court very clearly relied on U.S. federal income tax concepts regarding withholding taxes to conclude that the U.K. withholding tax on interest was imposed on the U.S. lender even though it was collectible only from the borrower. *Gleason Works, supra,* 58 T.C. at p. 479.

19 *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001); *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001).

20 For purposes of this holding period, periods in which a taxpayer has diminished his risk of loss are not taken into account (*i.e.*, in general, periods in which a taxpayer (i) has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially identical stock or securities; (ii) the taxpayer is the grantor of an option to buy substantially identical stock or securities, or (iii) under regulations, has diminished his risk of loss by holding 1 or more other positions with respect to substantially similar or related property). *See* sections 901(k)(5) and 901(l)(4).

21 1998-1 C.B. 334.

two classes of transactions in which the reasonably expected economic profit was insubstantial compared to the value of the credits expected to be obtained – (1) the acquisition of an asset that generates an income stream subject to foreign withholding tax, immediately prior to the payment of the income and withholding tax, similar to the transactions described in the immediately preceding paragraph, and (2) investment structures in which tax benefits are duplicated through the use of hybrid securities (which are treated as debt in one country and equity in the other) that enable both the U.S. taxpayer and a foreign counterparty to claim a credit for the same taxes incurred by the investment vehicle (or an equivalent exemption of the related income). The notice described an enhanced economic profits test that the IRS would apply to test such transactions. The notice also indicated that,

> In addition, Treasury and the Service are considering various approaches to address structures (including hybrid entity structures) and transactions intended to create a significant mismatch between the time foreign taxes are paid or accrued and the time the foreign-source income giving rise to the relevant foreign tax liability is recognized for U.S. tax purposes. For such structures and transactions, Treasury and the Service are considering either deferring the tax credits until the taxpayer recognizes the income, or accelerating the income recognition to the time at which the credits are allowed (*e.g.*, by allocating the credits or the income under section 482).

Faced with the loss of the *Compaq* and *IES Industries* cases, the IRS withdrew Notice 98-5 through the issuance of Notice 2004-19,[22] in which it announced that instead of challenging the targeted transactions under an enhanced economic profits test, it would use the principles and tools of existing law to scrutinize such transactions. Notice 2004-19 observed that the first category of abusive transactions listed in Notice 98-5 was addressed through Congress' enactment of section 901(k), dealing with withholding taxes on dividends, in 1997, and the then-pending proposal to expand that provision to other withholding taxes, which was enacted in 2004

[22] I.R.B. 2004-11 (February 17, 2004).

as section 901(l). The Notice also mentioned the Bush Administration's request, in its FY 2005 Budget, that Congress provide broad regulatory authority to address the second category of abusive transactions as well as other situations in which foreign taxes are inappropriately separated from the related foreign income. Congress did not include such a grant of regulatory authority in the 2004 tax legislation.[23]

Finally, Notice 2004-19 stated that, "Treasury and the IRS will use existing authority under section 901 and other provisions of the Code to address transactions or structures that produce inappropriate foreign tax credit results." The Notice identified two pending regulatory projects – (i) regulations addressing the allocation of foreign taxes by a partnership under section 704 (which were subsequently issued as temporary regulation section 1.704-1T(b)(4)(xi)) and (ii) regulations "concerning the application of the legal liability [*i.e.*, technical taxpayer] rule of § 1.901-2(f) in certain circumstances, including, for example, in the case of consolidated tax reporting systems in foreign countries. These regulations are intended to provide rules that make the allocation of foreign taxes imposed on the combined income of two or more persons more consistent with each person's respective share of the foreign income to which the tax relates."

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[23] The Administration's proposal for regulatory authority was reflected in section 661A of the Senate amendment for The American Jobs Creation Act of 2004 (H.R. 4520), but was not contained in the House bill. The legislation did not include the Senate amendment provision. Section 661A of the Senate amendment would have added a new section 901(m) to the Code, as follows: "The Secretary may prescribe regulations disallowing a credit under subsection (a) 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."

The Administration renewed its request for such regulatory authority in its FY 2006 Budget. The Joint Committee's explanation of the Administration's proposal describes, as one example of how taxpayers might attempt to separate foreign taxes from the related tax base, a foreign partnership that qualifies as a reverse hybrid entity and is owned by a U.S. corporation, similar to the *Abbot Laboratories* case. *See* JCT Print (JCS-3-05), "Description of Revenue Provisions Contained in the President's Fiscal Year 2006 Budget Proposal," p. 231 (2005).

Temporary regulation section 1.704-1T(b)(4)(xi), issued on April 20, 2004, effectively requires a partnership to allocate creditable foreign tax in proportion to the partners' distributive share of income to which the creditable foreign tax relates.[24]

In sum, in recent years Congress and the IRS have considered several situations involving the separation of creditable foreign taxes from the related income. In the case of withholding taxes, addressed in sections 901(k) and (l), Congress decided not to tamper with the technical taxpayer rule but instead to impose an additional holding period condition on the creditability of the foreign tax. On the other hand, in the case of partnership allocations, the IRS required a matching of the foreign tax to the related income, albeit pursuant to the statutory and regulatory scheme under section 704(b), whereby if an allocation (such as foreign tax credits) cannot have substantial economic effect, it must be made in accordance with the partners' interests in the partnership.

IV. SITUATIONS IN WHICH TAXES ARE SEPARATED FROM THE TAX BASE

Situations in which creditable foreign taxes are separated from the tax base to which they relate in the context of a group of related persons can arise as a result of (i) the operation of the consolidated tax regimes of certain countries, (ii) the presence of hybrid and/or reverse hybrid entities and/or (iii) the use of no-current-coupon hybrid securities or other hybrid arrangements. The separation can be effected, with similar benefits resulting, in the context of the section 901 direct credit or the section 902 indirect credit. Creditable foreign tax can be separated from the related tax base both where all of the relevant entities are taxpayers in the

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[24] The regulation is discussed in New York State Bar Association Tax Section, *Report on Temporary and Proposed Regulations Concerning Allocation of Creditable Foreign Tax Expenditures*, dated September 30, 2004, *reprinted in* 2004 TNT 198-18 (October 13, 2004) (the "Partnership Foreign Tax Credit Report").

same foreign country and in cross-border situations involving more than one foreign country. The cross-border situations can arise either as a result of the use of reverse hybrid entities or no-current-coupon hybrid securities, or as a result of foreign CFC-type regimes. To some extent, these results arise due to ambiguities regarding the scope of the current regulation. This Part illustrates the various contexts in which these consequences arise.

The most widely discussed consolidated tax regimes that ostensibly permit the separation of creditable foreign income taxes from the tax base to which they relate are Australia and Luxembourg.

Under Australia's "single entity" rule, members of an Australian consolidated tax group are effectively treated as divisions of the head company of the group, and the head company reports and pays tax for the entire group. While each member company is jointly and severally liable for the group's unpaid tax liabilities, no member has any such liability so long as the head company pays the group's tax on or before the due date. In addition, if the members of a group enter into a valid tax sharing agreement that provides for a reasonable allocation of the group's tax liabilities among the members (which need not be based on the relative amount of income earned by the members), the liability of each member (other than the head company, which remains liable for the entire amount) would depend on its allocated liability as per the agreement.[25] We understand that some U.S. multinational corporations with consolidated Australian subsidiary groups take the position that members (other than the head company) of that group do not have joint and several liability for Australian taxes because the group has a valid tax sharing agreement, and that each member should be treated as liable for the full amount

[25] *See* sections 721-15, 721-25, 721-30 and 71-40 of Division 721 of the Australian Income Tax Assessment Act 1997; Australian Tax Office, Receivables Policy Guidelines, Chapter 35 ("Collection of Consolidated Group Liabilities") sections 35.3.13, 35.4.33, 35.4.76 – 35.4.83 (2005).

of taxes (and only for such amount) that it is required to pay under the tax sharing agreement.[26] As a result, a separation of creditable foreign tax from the related tax base can occur to the extent that the tax sharing agreement provides for an allocation that does not comport with the relative amount of income earned by the members.

As described in the briefs and the expert witness reports in the *Guardian Industries* case, Luxembourg permits a "fiscal unity group" to file tax returns on a consolidated basis. Under this regime, each company files a separate tax return reporting its own, pre-consolidation, taxable income. In addition, the parent files a consolidated return that aggregates (and nets) the taxable income and loss of the various members of the group. The statute provides that the parent is liable to pay the tax liability of the group. The Luxembourg government's administrative practice is to issue a notice of assessment prior to the expiration of the statute of limitations that shows the parent as liable for the entire tax liability of the group (and as having the income of the members attributed to it) and the subsidiaries as having no taxable income and no tax liability. The taxpayer and the U.S. Government (as well as the reports of their respective expert witnesses) dispute whether under Luxembourg law the subsidiaries nonetheless remain liable for tax on their respective taxable income and whether there is a legal transfer of the taxable income and tax liability of the subsidiaries to the parent (and, if so, its relevance for U.S. tax purposes).[27]

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[26] In contrast, under U.S. tax principles, payments under a tax sharing agreement are treated as payments of taxes to the extent of such members' allocable share of the consolidated tax liability, based on relative amount of taxable income or of tax liability. *See e.g.*, Rev. Rul. 73-605, 1973 C.B. 109 (payments under tax sharing agreement within a U.S. consolidated group); LTR 8524043 (March 18, 1985) (applying Revenue Ruling 73-605 principles to a foreign consolidated tax group).

[27] *See generally* various briefs and other court filings: Guardian's Complaint, 2004 TNT 155-14 (Dec. 20, 2002); Court's Order, 2004 TNT 159-8 (Apr. 16, 2004); Guardian's Brief and Motion for Summary Judgment, 2004 TNT 160-9 (May 9, 2003); Declaration of Guardian's Expert Steichen, 2004 TNT 160-10 (May 5, 2003); Justice Department's Brief and Cross-Motion, 2004 TNT 161-9 (Jan. 7, 2004); Report of Government's Expert Elvinger, 2004 TNT 162-11 (Dec. 18, 2003); Second Steichen Declaration, 2004

In the *Guardian Industries* case, the parent of the Luxembourg fiscal unity group (GIE) was organized as a S.a.r.l, so that it was a corporation for Luxembourg tax purposes but a disregarded entity for U.S. federal income tax purposes whose sole member was a U.S. corporation. Therefore, under taxpayer's view of the Luxembourg and U.S. tax laws, the Luxembourg income tax paid by GIE on behalf of the Luxembourg fiscal unity group was eligible for a direct foreign tax credit under section 901. A similar result could have been obtained even if GIE were a corporation for U.S. federal income tax purposes, by having GIE earn a modest amount of income (*e.g.,* dividends from a subsidiary that qualify as general basket income) in excess of the amount of Luxembourg income tax that it pays on behalf of its subsidiaries, and then pay a dividend of its entire after-tax earnings and profits to its U.S. parent. In that event, the U.S. parent would have been eligible for an indirect credit under section 902.[28]

The briefs and expert witness reports in the *Guardian Industries* case illustrate some of the difficulties that are faced by taxpayers and the IRS in determining whether the parent of a foreign consolidated tax group is solely liable for the tax liability of the group under foreign law (and within the meaning of the U.S. tax regulation). Similar uncertainties are presented by the Australian tax regime, which relieves the subsidiaries of liability (i) if they enter into a valid tax sharing agreement (to the extent the liability is in excess of the amount reasonably allocated to the subsidiaries under the agreement) or (ii) if the parent discharges the tax liability of the group. It is likely, however, that other foreign consolidated tax regimes also present interpretative challenges. For example, in private letter ruling 200225032 (March 20, 2002), the

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TNT 163-46 (Feb. 4, 2004); Plaintiff's Reply Brief in Opposition, 2004 TNT 162-12 (Feb. 9, 2004); Justice Department's Reply Brief, 2004 TNT 164-20 (Aug. 5, 2004).

[28] In both the section 901and 902 situations, the benefit would be diluted to the extent that the GIE paid the group's Luxembourg income tax liability from the proceeds of a dividend in an equivalent amount that it received from its subsidiaries, instead of paying the tax liability from its capital (or from borrowings or contributions from its U.S. parent).

IRS concluded that the German income tax that was paid by the parent of a German organschaft (consolidated tax group) should be allocated among the members of the group on the grounds that taxpayer's German counsel opined that the German tax authorities would likely assess and collect tax from the subsidiaries in the event that the parent failed to pay the tax, and that this was tantamount to joint and several liability under section 1.901-2(f)(3). We understand, however, that some U.S. taxpayers and their counsel take the position that the subsidiaries in a German organschaft do not have joint and several liability for the group's taxes within the meaning of the regulation and that this tax regime can therefore be used to separate creditable foreign taxes from the related tax base.

It is not necessary to benefit from a favorable foreign consolidated tax regime in order for a group of entities to separate creditable taxes from the related tax base. The results that the taxpayer sought to achieve in *Guardian Industries* can be replicated virtually anywhere, using a combination of hybrid and reverse hybrid entities. For example, a U.S. multinational group can set up its Country X operations using a Country X parent company ("A") with operating subsidiaries that are structured as reverse hybrid entities. Under Revenue Rulings 58-518 and 72-197, A would be treated as solely liable for the Country X income tax liability of its reverse hybrid operating subsidiaries but would not be treated as earning any of their income, and the U.S. corporation that owns A would be eligible for either a direct credit for the Country X income taxes paid by A (if A is a hybrid entity) or an indirect credit for those taxes (if A is a corporation for U.S. tax purposes). Alternatively, the U.S. multinational group could simply conduct its Country X operations through a reverse hybrid entity, closely following the pattern of Revenue Ruling 72-197 or *Abbot Laboratories*.

Separation of creditable foreign taxes from the related tax base can also arise in cross-border situations involving more than one foreign country. The cross-border situations can arise as a result of the use of reverse hybrid entities or no-current-coupon hybrid securities, or as a result of foreign CFC-type regimes.

For example, assume that foreign entity A, a Country X subsidiary of U.S. multinational company M, owns subsidiary B, organized and doing business in Country Y. Assume further that Country X is a tax haven, and that B is treated as a tax-transparent entity under the laws of Country Y but as a corporation for U.S. federal income tax purposes. As in the preceding example (involving a reverse hybrid structure in a single foreign country), under the foregoing revenue rulings, A would be treated as solely liable for the Country Y income tax liability of B, its reverse hybrid subsidiary, but would not be treated as earning any of its income for U.S. federal income tax purposes. M would be eligible for either a direct credit for the Country Y income taxes paid by A (if A is a hybrid entity) or an indirect credit for those taxes (if A is a corporation for U.S. tax purposes).

On the other hand, not all cross-border situations involving more than one foreign country and a reverse hybrid subsidiary are as problematic from a U.S. tax perspective. Assume, for example, that in the previous situation, (i) Country X is a high-tax jurisdiction, (ii) B is a tax-transparent entity under the laws of Country X but is a corporation for purposes of U.S. and Country Y tax laws, (iii) both A and B conduct bona fide business operations in their respective countries, and (iv) A has an incremental tax liability in Country X in respect of its share of B's income, after applying a credit for Country Y taxes incurred by B. Although the incremental Country X tax paid by A in respect of B's income will be creditable by M for U.S. federal income tax purposes without M having to include the earnings of B to which this incremental tax

relates, the separation between creditable foreign taxes and the related income in this situation is ancillary to bona fide business activity in the two countries and relates only to the incremental taxes incurred in Country X. Such a separation is unlikely to be planned for the purpose of securing a U.S. tax benefit since ordinarily a taxpayer is unlikely to arrange its affairs so as to incur unnecessary incremental foreign taxes in another country if the related income is exempt from that incremental amount of tax both in the country in which the income arises (Country Y) and in the United States. A similar result would occur if B were not tax-transparent for Country X (or Country Y) purposes but all or a portion of its income were currently taxable to A under a CFC-type anti-deferral regime[29] in Country X (but such income is not Subpart F income).

It may also be possible to use no-current-coupon hybrid securities to separate creditable foreign taxes from the related income, both in cross-border situations and within a single foreign country. By way of illustration, assume that U.S. corporation M owns Country X corporation A, which in turn owns Country X corporation B, and that instead of organizing B as a reverse hybrid entity, A holds a hybrid security of B. The hybrid security is structured so as to be treated as equity for U.S. tax purposes but as debt for Country X tax purposes. The hybrid security accrues (but does not pay) a current yield that is sufficient to soak up all or a substantial portion of B's income, and is structured to avoid the accrual rules of section 305. As a result, A would be subject to Country X tax each year in respect of an amount of income equal to the accreting coupon on the hybrid security (and this tax would be creditable by M under section 901

[29] Many countries have tax rules that are broadly similar to the U.S. controlled foreign corporation rules, under which a taxpayer is taxed currently on certain categories of income earned by subsidiaries located outside the country, such as passive income of foreign subsidiaries generally or income earned by subsidiaries organized in tax havens.

or 902 depending on whether A is a disregarded entity for U.S. tax purposes), while the related income would be treated as income of B for U.S. tax purposes.[30]

V. POLICY CONSIDERATIONS.

The situations described above raise the questions of (i) whether the separation of creditable foreign taxes from the related income is inappropriate as a policy matter in any or all of the foregoing situations, and (ii) if so, what policies should inform any changes to the regulations to correct these inappropriate results. An additional policy question is whether the regulations should be modified in a narrow manner to address only consolidated tax regimes or whether they should also cover any or all of the other situations discussed in Part IV – in particular, reverse hybrid structures, no-current-coupon hybrid securities and/or cross-border situations.

A. Policy Considerations Relating to the Separation of Creditable Foreign Taxes From the Related Income.

The principal policy objective of the foreign tax credit is to prevent double taxation of a taxpayer's foreign source income.[31] Consistent with that objective, since 1921 the tax law has contained a limitation to prevent a taxpayer from using foreign tax credits to offset U.S. tax on U.S. income. Over its history, the limitation has varied from an overall limitation based on the taxpayer's total foreign income, to a per-country limitation, to various permutations of limitation based on separate categories (or "baskets") of income. These adjustments from time to time in the limitation have sought to achieve a reasonable matching between the credit

30 Similar opportunities to separate creditable foreign taxes from the related income may arise through the use of other hybrid arrangements, such as transactions that are treated as leases or licenses under foreign tax law but as equity investments by one related person in another for U.S. tax purposes.

31 *See, e.g., American Chicle Co. v. United States*, 316 U.S. 450, 452, (1942); Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, p. 861 (1987) (the "1986 Blue Book").

and an associated class of income at a reasonable administrative cost. The perception of what is a reasonable matching and what is a reasonable administrative cost has varied over time, but there has never been a perfect matching of creditable tax to the related income on an item of income-by-item of income basis. Apart from being administratively unworkable, such an item-by-item tracing would produce results that would probably be considered overly restrictive as a policy matter. Thus, the foreign tax credit rules have always allowed for some averaging of different tax rates applied to different items of income ("cross crediting").[32]

Additionally, the foreign tax credit rules accommodate both timing and absolute differences between U.S. and foreign tax bases, so that a credit may be available with respect to a disproportionately small amount of income (as determined under U.S. tax principles).[33]

Based on the foregoing rules, U.S. multinational groups routinely arrange their foreign subsidiaries, and time dividends therefrom, so as to maximize their ability to utilize foreign tax credits (for example, by optimally blending low-taxed and high-taxed streams of income within the same "basket").

In view of the foregoing, it may be asked whether, as a policy matter, the separation of creditable foreign taxes from the related tax base in the situations under discussion herein present an abuse that is in need of curtailment.

Perhaps it is a question of degree, but to our mind the separation of creditable foreign taxes from the related tax base in these situations is qualitatively different and

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[32] *See generally*, *id.*, at pp. 854-855, 861-863. The foreign tax credit limitation, found in section 904, applies to both the direct and indirect credit. In addition, the indirect credit has a separate matching rule between the creditable taxes and the earnings pool to which the taxes relate. Reflecting a changed perception of what is a reasonable matching and reasonable administrative cost, beginning in 1987 a single post-1986 earnings pool is utilized, whereas for prior years (and for years before a foreign corporation has a 10% U.S. shareholder), the matching is done on a year-by-year basis. *See* section 902(a), (c).

[33] *See* section 1.904-6(a)(iv) (special rules for base and timing differences). *See also* section 904(d)(2)(H) (as enacted in the American Jobs Creation Act of 2004, generally effective for tax years beginning after December 31, 2006).

distinguishable from the cross-crediting and other aspects of current law described above. Each of the cross-crediting and other aspects of current law reflects a judgment on the part of Congress or the IRS as to how best to achieve a reasonable matching between a creditable foreign tax and the related tax base at an acceptable administrative cost, within the overall objective of preventing double taxation. None of the features of the current rules that allow cross-crediting permit a complete and indefinite separation between creditable foreign taxes and the related tax base. And the base/timing differences rules are designed to achieve the fairest result (*i.e.,* allowing a credit for foreign taxes) that is reasonably possible under the circumstances.

By contrast, the situations under discussion create an artificial and indefinite mismatch between creditable foreign taxes and the related tax base, and unless there are compelling administrative considerations that require such a result, this result does not in any way advance – indeed, it subverts – the policy objectives of the foreign tax credit. Moreover, unless the Treasury and the IRS revise the regulations, an increasing number of taxpayers will likely exercise self-help to claim foreign tax credits without including the related tax base in income, thereby undermining the integrity of the foreign tax credit system. We believe that this result can be prevented without undue administrative cost. Therefore, in our view, it is appropriate and desirable for Treasury and the IRS to amend the regulations to limit the opportunities for taxpayers to separate within related entities the creditable foreign taxes from the related tax base.

We note that amending the regulations to better match creditable foreign taxes and the related tax base in the situations discussed herein would be consistent with recent steps by Congress and the IRS to address mismatches between creditable taxes and the related tax base in other contexts, in particular through the enactment of sections 901(k) and (l), dealing with

withholding taxes, and the promulgation of regulation section 1.704-1T(b)(4)(xi), dealing with partnership allocations of foreign tax credits.

B. Policy Considerations Relating to Reverse Hybrid Entities, No-Current-Coupon Hybrid Securities and Cross-Border Situations.

Because regulation section 1.901-2(f)(3) focuses on the combined income of two or more related persons, such as a corporation and its subsidiaries, it might be contended that any changes to the regulation should be limited to addressing the problems presented by consolidated foreign tax regimes. One possible reason for limiting any changes to the regulation in this manner would be that the problems presented by reverse hybrid (and hybrid) entities, no-current-coupon hybrid securities and cross-border situations arise from the application of different sets of legal rules. In particular, certain consolidated foreign tax regimes present the issue of when a given member of the consolidated group has legal liability for a tax under the technical taxpayer rule. On the other hand, hybrid and reverse hybrid structures may take advantage of arbitrage opportunities between the foreign and U.S. classifications of entities as tax-transparent or taxable entities. Similarly, no-current-coupon hybrid securities (and other hybrid arrangements) take advantage of arbitrage opportunities between the foreign and U.S. tax characterization of economic interests as debt (or a lease or license) vs. equity. And cross-border situations involve CFC-type regimes and/or reverse hybrids or no-current-coupon hybrid securities. Arguably, therefore, each of these circumstances implicates a different set of policies and concepts, and merits a different solution.

In addition, it would seem to be relatively straightforward to amend section 1.901-2(f)(3) to address consolidated tax regimes. For example, this could be achieved by providing that for purposes of the regulation, persons will be treated as "jointly and severally liable for the income tax under foreign law" even where one or more of such persons is only

secondarily liable, is liable only if a primary obligor does not pay the tax, is relieved of liability if (or immediately before) another person pays the tax, is liable under contract (such as under a tax sharing agreement) and/or has several but not joint liability (even for only a portion of the tax). Arguably, hybrids, reverse hybrids, no-current-coupon hybrid securities and cross-border situations raise more complex issues and would require more extensive changes to current law.

Nonetheless, we believe that it would be a mistake for Treasury and the IRS to address only those situations in which a foreign consolidated tax regime is involved and to ignore situations in which the separation between creditable foreign taxes and the related tax base arises through the use of reverse hybrid (and/or hybrid) entities or no-current-coupon hybrid securities. As discussed in Part IV above, structures using reverse hybrid entities can replicate the results achieved by the taxpayer in *Guardian Industries* and other situations in which consolidated tax regimes are utilized to separate creditable foreign taxes from the related tax base. Moreover, the reverse hybrid and no-current-coupon hybrid securities structures are more troublesome because they can be employed to achieve these results virtually anywhere in the world.

Furthermore, we are persuaded that notwithstanding the somewhat different technical legal underpinnings of these structures from those of certain consolidated foreign tax regimes, the fundamental problem – namely, the separation between creditable foreign taxes and the related tax base within a group of related persons – is the same. Moreover, we believe that this fundamental problem can and should be addressed through a uniform and neutral set of rules – described in Part VII below – that treats reverse hybrid (and hybrid entities) no differently than other entities.[34] In this regard, as a policy matter, we see no reason to exempt from the scope of

[34] Thus we see no need to address the reverse hybrid and hybrid structure situations through special anti-abuse rules for hybrids. Apart from being unnecessary, we believe that such an anti-abuse approach would

such rules a situation, such as that presented in *Abbot Laboratories* or Revenue Rulings 58-518 and 72-197, where the foreign country directly imposes tax on one or more U.S. partners of a reverse hybrid entity solely in respect of its share of the entity's income (rather than on the partner's worldwide income, under a full combined income tax regime). Therefore, we recommend that any amendment to the regulation treat all situations in which related persons separate a creditable foreign tax from the related tax base in a consistent manner, regardless of whether the separation is effected through use of a foreign consolidated tax regime or through the use of reverse hybrid and hybrid entities, no-current-coupon hybrid securities or other hybrid arrangements.

As discussed in Part IV above, certain cross-border situations involving more than one foreign country raise the same concerns as reverse hybrid structures or no-current-coupon hybrid securities in a single foreign country, while other cross-border situations do not necessarily raise such concerns. One approach that might be considered in order not to impose undue complexity on bona fide cross-border business activities while countering potential abuses would be to provide that cross-border situations generally would not be subject to an amended regulation section 1.901-2(f)(3) unless there is a tax avoidance purpose to the arrangement, and to include examples of tax avoidance and non-tax avoidance cases in the regulation. Alternatively, the proposed changes could apply without exception to all cross-border situations in which there is a separation of creditable tax from the related tax base. On balance, we recommend that our proposed changes apply without exception to all cross-border situations, because (i) we do not believe that "innocuous" or "natural" separations of tax credit from the

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likely produce a vaguer and less clearly administrable standard, and would require a careful and complex analysis of the broader scope issues relating to when the check-the-box entity classification rules should be over-ridden by anti-abuse rules. For similar reasons, we believe that structures involving no-current-coupon hybrid securities and other hybrid arrangements can better be addressed through the proposals described in Part VII below.

related tax base merit an exception from the general rule and (ii) the slight complexity of having to apply the proposed new rules to such arguably "benign" cases is outweighed by the greater overall clarity and certainty of not having to apply a tax avoidance standard to all cross-border situations.

C. Policy Considerations Relating to the Formulation of Specific Amendments to the Regulations.

We understand that in undertaking this regulatory project to address concerns regarding the separation between creditable foreign taxes and the related tax base of related persons, Treasury and the IRS wish to work, to the extent possible, within the existing framework of the technical taxpayer rule.

We concur that such an approach is desirable because it would preserve the benefits of simplicity, certainty and administrability afforded by the technical taxpayer rule in the many situations that do not involve structures that are designed to separate, within related entities, a creditable foreign tax from the related tax base. Also, as discussed in Part VI below, such an approach avoids any possible issues regarding the IRS' regulatory authority in this regard. Aside from questions of regulatory authority, working within the existing framework of the technical taxpayer rule rather than, for example, replacing it with a general rule that grants a foreign tax credit to the person that bears the economic burden of the tax or that earns the related income, obviates the need to undertake an extensive reconsideration of the foreign tax credit rules and the collateral implications of such a significant change.

We believe that the separation between creditable foreign taxes and the related tax base in the situations discussed herein can be addressed effectively through a carefully tailored expansion of section 1.901-2(f)(3), and would not require a wholesale reconsideration or abandonment of the technical taxpayer rule, as set forth in section 1.901-2(f)(1). The key

components of our recommendation are (i) to eliminate the "joint and several" condition from section 1.901-2(f)(3), (ii) to expand the definition of "combined income" and "related person" in the regulation so that the regulation clearly covers the situations discussed herein, and (iii) to provide that the portion of the tax base that belongs to each related person (and consequently the amount of foreign tax attributable thereto) is to be determined under U.S. tax principles in a manner consistent with the principles underlying the foreign tax credit rules. The regulatory authority to amend the regulation in this manner is discussed in Part VI below, and is followed by a more developed description and explanation of our recommendation in Part VII below.

VI. REGULATORY AUTHORITY.

This Part discusses two aspects of the regulatory authority question – (i) what affirmative authority exists for amending section 1.901-2(f)(3) to address the situations discussed herein, and (ii) whether the *Biddle* case and long-standing practice under the technical taxpayer rule and/or Congress' failure last year to grant the expanded authority that Treasury and the IRS requested under the foreign tax credit rules might prevent or limit Treasury and the IRS from amending the regulation to address the situations discussed herein.

We believe that affirmative authority for amending the regulation to address the separation between creditable foreign taxes and the related tax base in the situations discussed herein exists under sections 482 and 7805.

Section 482 provides that,

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in

order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

Section 482 by its terms permits the allocation of credits, and it has been applied so as to allocate foreign tax credits among related taxpayers.[35] For example, in Revenue Ruling 72-371,[36] the IRS ruled that where, under section 482, it reallocated to the U.S. parent royalty income that had been paid by one foreign subsidiary to another (and that was subject to a withholding tax), the U.S. parent was entitled under section 482 to a credit for the portion of the withholding tax that the U.S. parent would have been subject to if the royalty had been paid directly to it.[37]

Thus, for example, we believe that section 482 can serve as authority for an amendment to section 1.901-2(f)(3) that would attribute to each related person the portion of the creditable foreign tax that is attributable to its portion of the base of tax, even where such persons are not jointly and severally liability for the tax.[38] In this regard, it would appear that in each of the situations discussed in Part IV above (whether involving a consolidated group or a reverse

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35 On the other hand, *Schering Corp. v. Commissioner,* 69 TC 579 (1978) held that section 482 does not allow the IRS to *disallow* a foreign tax credit. This decision is consistent with cases holding that section 482 permits only the distribution, apportionment, or allocation of a deduction, not its disallowance. *See, e.g., Hypotheek Land Co. v. Commissioner*, 200 F.2d. 390, 396 (9th Cir., 1952); *Hearst Corp. v. Commissioner*, 14 T.C. 575, 577 (1950).

36 1972-2 C.B. 438. Interestingly, this ruling in effect overruled technical advice memorandum 6806061180A (June 6, 1968), in which the IRS concluded that "credits" in section 482 did not encompass foreign tax credits and that no allocation of the withholding tax to the U.S. parent to conform to the income reallocation was possible, because there was no indication in the legislative history of the predecessor of section 482 that Congress intended to allocate foreign tax credits in a manner that conflicted with *Biddle*.

37 The IRS has also addressed in a series of rulings what adjustments need to be made under section 482 in the amount of creditable foreign taxes of a subsidiary as a result of an adjustment of the subsidiary's income under section 482. *See* Revenue Rulings 72-370, 1972-2 C.B. 437; 76-508, 1976-2 C.B. 225; 80-231, 1980-2 C.B. 219.

38 In virtually all of the situations that are described in Part IV above and are covered by the proposals in Part VII below, one of the related persons controls the other or they are under common control, within the meaning of section 482. The proposals also encompass a situation where a foreign tax-transparent entity has many members (*i.e.*, is a partnership for foreign tax purposes), and the foreign tax is imposed on its members. Regulatory authority to apply the proposals to members that do not satisfy the section 482 control test would need to be based on section 7805(a) or, if it is enacted, the expanded regulatory authority requested by the Administration in its FY 2006 Budget (*see* footnote 23 above).

hybrid structure), each such allocation of taxes from one person to a related "person" would be made to a person that is not a disregarded entity for U.S. tax purposes,[39] and therefore there is no issue as to whether section 482 encompasses allocations between business units of a single person. We note however, that even if that were not the case, section 482 covers "two or more organizations, trades, or businesses (whether or not incorporated, whether or not in the United States, and whether or not affiliated)," and the regulations thereunder interpret those terms expansively.[40] While neither the regulations nor any authority of which we are aware explicitly provides that "two or more organizations, trades or businesses" includes a corporation or partnership and a disregarded entity thereof (or two disregarded entities thereof), it seems relatively clear that such relationships are encompassed within the scope of section 482.

Given the existing regulations under section 901 and the other authorities articulating the technical taxpayer rule, it is unclear whether the IRS could, in the absence of a regulatory amendment, apply section 482 to require a matching between the creditable foreign tax and the related tax base in the situations under discussion.[41] In any event, however, section 482 certainly provides authority for Treasury and the IRS to amend section 1.901-2(f)(3) on a prospective basis.

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[39] The separation between creditable foreign taxes and the related taxbase can occur only if the taxes and tax base are in entities that are separate, non-tax transparent persons for U.S. tax purposes, because if one of those entities is a tax-transparent subsidiary of the other (or if both are tax-transparent subsidiaries of a third entity), the tax base of the tax-transparent entity would be attributed to its member and such separation would not be effective.

[40] *See* section 1.482-1(i)(1), (2), (3).

[41] The Court of Federal Claims could as a theoretical matter be faced with that question in the *Guardian Industries* case in the event it concludes that the subsidiaries do not have joint and several liability under Luxembourg law. However, the Government has not made that argument. Instead, the Government has argued that section 1.901-2(f)(3) is not the exclusive basis for matching a creditable foreign tax with the related tax base in the context of a consolidated group, and that the matching principle is inherent in the concept of who is liable for the tax under the technical taxpayer rule, as evidenced by the withholding tax cases cited in footnote 17 above. *See* Government's Reply Brief, *supra*, 2004 TNT 164-20 (Aug. 5, 2004).

Regulatory authority for amending the section 1.901-2(f) regulation also is provided by section 7805(a), which authorizes Treasury and the IRS to "prescribe all needful rules and regulations for the enforcement of this title."

We do not believe that either (i) the *Biddle* case and long-standing practice under the technical taxpayer rule or (ii) Congress' failure last year to grant the expanded regulatory authority that Treasury and the IRS requested under the foreign tax credit rules would prevent or limit Treasury and the IRS from amending the regulation in the manner recommended in this report to address the situations discussed herein.

Biddle itself simply held that a shareholder of a foreign corporation in an integrated tax system cannot claim a credit for corporate income taxes paid by the corporation, even where the shareholder's foreign tax liability (or eligibility for a refund) in respect of dividends received from the corporation takes account of taxes paid by the corporation in respect of the earnings underlying the dividend, because "our statutes . . . have never treated the stockholder for any purpose as paying the tax collected from the corporation. Nor have they treated as taxpayers those upon whom no legal duty to pay the tax is laid."[42] Notwithstanding the subsequent formulation of the technical taxpayer rule in post-*Biddle* revenue rulings, we do not believe that one must necessarily interpret *Biddle* as also making the converse statement that "our statutes always provide a credit to the person upon whom legal liability to pay the tax is laid." Indeed, it seems clear that the withholding tax cases discussed in Part III.B above agree with our reading of *Biddle*. Therefore, we do not believe that *Biddle* precludes Treasury and the IRS from issuing regulations (whether under authority of section 482 or section 7805(a)) that

[42] 302 U.S. at 581.

prevent a group of related persons from separating foreign tax credits from the related tax base and thereby claiming a credit without taking the related income into account.

We recognize that our recommendation that the "joint and several" condition be removed from section 1.901-2(f)(3) modifies the scope of the technical taxpayer rule, in the limited context of taxes that are imposed on the combined income of related entities, from the very narrow articulation of that rule in the *Biddle* line of revenue rulings. However, as noted herein, we do not believe that this very narrow articulation is mandated by *Biddle* or by any other case, Code provision or Congressional pronouncement. Indeed, regulations and case law have already adopted a broader interpretation of the technical taxpayer rule in the context of withholding taxes, as noted in Part III.B above. The withholding tax authorities make clear that the focus is on the person upon whom the tax is "imposed" from a U.S. tax perspective (*i.e.*, the lender, which earned the interest income) rather than on the person from whom the tax is collectible as a legal or practical matter. So too, in the case of a group of related entities whose combined income is subject to tax, it should be an acceptable interpretation of the technical taxpayer rule to say that, even without joint and several liability, "foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of the tax, regardless of which person actually pays the tax."[43]

We are not aware of any legal doctrine that prevents Treasury and the IRS from duly exercising their regulatory authority to narrow, modify or even reverse a long-standing regulation or other administrative rule where Treasury and the IRS consider such a change to be necessary or appropriate to prevent abuse or to further the purpose of the relevant Code

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[43] *See* section 1.901-2(f)(3).

provision. True, courts do give deference to long-standing administrative interpretations of statutory provisions, particularly when the court discerns that Congress has approved the interpretive rules through reenactment of the statute.[44] However, such deference typically is exhibited for the purpose of upholding an interpretive regulation against challenge, not to preclude the administrative agency from modifying the rule.[45] Moreover, courts recognize that not every administrative interpretation should be given extra deference under the reenactment rule, if for no other reason than that Congress rarely is aware of the details of outstanding regulations.[46] As one leading commentator concluded, the concepts of deference to administrative rules that are of long-standing interpretation or Congressional reenactment "are tools in the hands of judges who are interpreting statutes, and the judges use the tools as they see fit, along with other implements of interpretation."[47]

While references to *Biddle* do appear in the legislative history of various changes to the foreign tax credit rules, they relate to the broader issue of applying foreign and U.S. law in

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[44] *See, e.g., United States v. Correll,* 389 U.S. 299, 305-06 (1967), *quoting Helvering v. Winmill,* 305 U.S. 79, 83 (1938); *United States v. Stapf,* 375 U.S. 118, 127 n.11 (1963); *Commissioner v. Flowers*, 326 U.S. 465, 469 (1946).

[45] *See, e.g., Helvering v. R. J. Reynolds,* 313 U.S. 428 (1941) (The doctrine of legislative reenactment "is no more than an aid in statutory construction. While it is useful at times in resolving statutory ambiguities, it does not mean that the prior construction has become so imbedded in the law that only Congress can effect a change. It gives way before changes in the prior rule or practice through exercise by the administrative agency of its continuing rulemaking power."); *Commissioner v. P.G. Lake, Inc.,* 356 U.S. 260, 265-66 n.5 (1958) (prior administrative action always subject to change through exercise by administrative agency of its continuing rulemaking power).

[46] *See, e.g., Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426, 431 (1955) ("Reenactment . . . is an unreliable indicium at best"); *Biddle v. Commissioner, supra,* 302 U.S. at 582 ("Where the law is plain the subsequent reenactment of a statute does not constitute the adoption of its administrative construction."). *See also F.W. Woolworth Co. v. United States*, 91 F.2d 973, 976 (2d Cir. 1937), *cert. denied,* 302 U.S. 768 (1938) ("To suppose that Congress must particularly correct each mistaken construction under penalty of incorporating it into the fabric of the statute appears to us unwarranted; our fiscal legislation is detailed and specific enough already.")

[47] Kenneth Culp Davis, Administrative Law Text (1972), p. 133.

this context rather than to the scope of the technical taxpayer rule.[48] The legislative history of the various amendments to the foreign tax credit rules, including the enactment of sections 901(k) and (l), do not provide any indication that Congress intended a broad application of the technical taxpayer rule for purposes of determining who is liable for the combined taxable income of related persons.

As for Congress' failure last year to grant the expanded regulatory authority that Treasury and the IRS requested under the foreign tax credit rules, the legislative history to the Senate bill states that that provision "*expands* existing regulatory authority to provide Treasury and the IRS *additional mechanisms* to address the . . . inappropriate separation of foreign taxes from the related foreign income."[49] Thus, that proposal implicitly acknowledges that Treasury and the IRS have authority under existing law to address this problem, which is consistent with the IRS' position in Notices 98-5 and 2004-19. The amendments to the regulation that are proposed herein would be implemented within the framework of the technical taxpayer rule, and pursuant to the authority discussed in this Part.

VII. PROPOSED AMENDMENTS TO THE REGULATION.

As already noted, we believe that the separation between creditable foreign taxes and the related tax base in the situations discussed herein can be addressed effectively through a carefully tailored expansion of section 1.901-2(f)(3), and would not require a wholesale

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48 *See* 1986 Blue Book, *supra*, at p. 852; H.R. Rep. No. 1033, 85th Cong. 1st Sess., p. 2 (1957). *See also* JCT Print (JCS-6-91), "Background and Issues Relating to Taxation of Investment Outside of the United States by U.S. Persons," n. 31 (1991); JCT Print (JCS-3-01), "Study of the Overall State of the Federal Tax System and Recommendations for Simplifications, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986," 107th Cong. 1st Sess., n. 147 (2001).

49 Conf. Rep. No. 108-755, 108th Cong. 2d Sess., p. 784 (2004) (emphasis added). *See* also footnote 23 above.

reconsideration or abandonment of the technical taxpayer rule, as set forth in section 1.901-2(f)(1).

Specifically, we recommend that section 1.901-2(f)(3) be amended by:

a. Removing the "joint and several" condition;

b. Providing that "a foreign income tax is imposed on the combined income of two or more related persons" (A) whenever the tax base on which the foreign income tax is imposed includes, at least in part, income of two or more (U.S. or foreign) related persons, regardless of whether that is true for U.S. or foreign tax purposes (or includes an amount that is income of one related person for U.S. tax purposes but is income of another for foreign tax purposes), and (B) even if the relevant tax base of one or more of such related persons is limited to income that is connected with the foreign tax jurisdiction rather than worldwide income, but (C) generally not if the tax is imposed under (i) an integrated tax system (*e.g.,* where, for purposes of computing its own tax liability, the owner of an interest in a person is eligible for a credit in respect of its share of the taxes paid by, or an exclusion in respect of its share of the income of, such person) or (ii) a group relief system such as in the U.K. (where each company computes its liability on a stand-alone basis but companies within the group can surrender losses to affiliates);[50]

c. Providing that for this purpose, a "person" includes a tax-transparent entity, whether under U.S. or foreign law;

d. Providing that the requirement that the persons be "related" be interpreted broadly to cover any definition of relatedness under the applicable foreign law as well as a transparent entity and its members (with respect to such member's share of the tax base of the transparent entity);

e. Providing that the "portion of the base of the tax" that belongs to each such person is to be determined under U.S. tax principles in a manner consistent with the principles underlying the foreign tax credit rules, so that if an amount is treated as income of one related person for U.S. tax purposes but as income of another for foreign tax purposes, "foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of the tax" as determined for U.S. tax purposes in a manner consistent with the principles underlying the foreign tax credit rules; and

[50] The exceptions for integrated and group relief tax systems would not apply to the extent a separation between creditable taxes and the related tax base occurs as a result of a reverse hybrid structure or no-current-coupon hybrid security (or other hybrid arrangement).

f. Clarifying that where the taxpayer is a partnership for U.S. federal income tax purposes, temporary regulation section 1.704-1T(b)(4)(xi) (dealing with the allocation of foreign tax credits among partners) should apply after section 1.901-2(f)(3).

Proposals "a" through "d" above would expand the scope of the "combined income of two or more related persons" concept of section 1.901-2(f)(3) so that that provision applies to every situation discussed in Part IV above in which creditable foreign taxes are separated, within related entities, from the tax base to which they relate. Thus, the revised regulation would apply regardless of whether (i) this result is obtained through the use of foreign consolidated tax regimes (such as Australia or Luxembourg), reverse hybrid entities (either as the result of "check-the-box" elections or "natural" reverse hybrids) or no-current-coupon hybrid securities (or other hybrid arrangements), (ii) the upper-tier entity is a hybrid, so that the benefit is claimed under section 901, or not, so that the benefit is claimed under section 902, (iii) the creditable foreign taxes are imposed on a foreign person or on a U.S. person that is a member of a foreign person (as in the *Abbot Laboratories* case) or (iv) the separation between the foreign taxes and the tax base occurs in entities that are within a single foreign country or in cross-border situations involving more than one foreign country. These proposed changes would eliminate controversies between the IRS and taxpayers as to the precise nature of the legal liability of various members of certain consolidated tax regimes. Also, these proposed changes would neither discriminate against nor favor reverse hybrid (or hybrid) entities or no-current-coupon hybrid securities, but would simply make the use of such entities or other arrangements irrelevant to the analysis.

The foregoing proposed changes would reverse the results in Revenue Rulings 58-518, 72-197 and 77-209, but would preserve the result in *Biddle* and would be consistent with both the narrow holding and the broader dicta in *Abbot Laboratories*. Thus, these proposed

changes would apply to a situation, such as that presented in *Abbot Laboratories* or Revenue Rulings 58-518 and 72-197, where the foreign country directly imposes tax on one or more U.S. partners of a reverse hybrid entity solely in respect of its share of the entity's income (rather than on the partner's worldwide income, under a full combined income tax regime).

Proposal "e" is intended to ensure that the tax and related tax base are matched in the same entity (whether or not tax-transparent) that is treated as the taxpayer, and thus as having the related earnings, for U.S. tax purposes. Accordingly, in the case of a reverse hybrid entity, the tax and related tax base would both be attributed to that entity rather than to its member(s), even if foreign tax law were to attribute the tax base directly to, and impose tax on, its member(s). Stated differently, proposal "e" is simply a "situs" rule: While the amounts of the foreign tax and the related tax base would continue to be determined under foreign law, proposal "e" would apply U.S. tax principles in a manner consistent with the principles underlying the foreign tax credit rules to determine the respective portions thereof that belong to each entity. The general foreign tax credit rules would then operate in respect of the amounts of tax and tax base attributed to each such entity under this special rule.[51]

To illustrate, assume that U.S. multinational M owns a Country X hybrid entity (A), which in turn owns a Country X reverse hybrid operating subsidiary (B). B has net profits

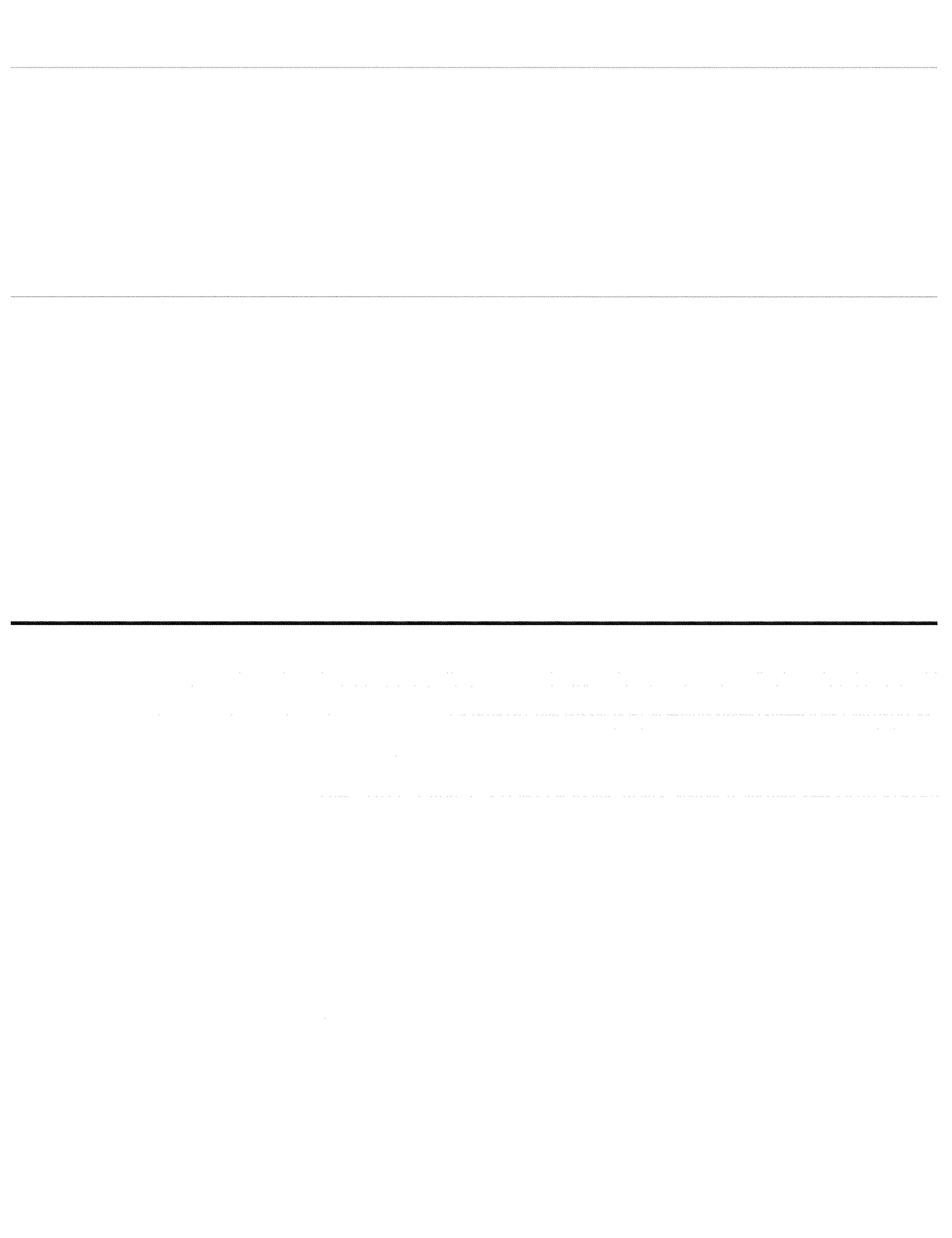
[51] Thus, for example, once the tax base and related foreign tax are attributed to the proper entity under proposal "e," section 1.904-6(a)(iv) would apply in respect of base or timing differences in the amounts determined for U.S. and foreign tax purposes.

Use of U.S. tax principles to determine the entity to which creditable foreign taxes and the related tax base belong in the context of section 1.901-2(f)(3) does not appear to raise particular issues or to be inconsistent with other aspects of the foreign tax credit rules. For example, while foreign tax principles generally determine the identity and amount of the relevant foreign tax base and the amount of foreign taxes attributable thereto (*see* section 1.904-6(a)), U.S. tax rules are taken into account in allocating certain expenses to the gross income in the foreign tax base (*see id.*). Other aspects of the foreign tax credit computation also are governed by U.S. tax rules (including, most significantly, earnings and profits pools under section 902 and separate section 904 income categories), and relatively straightforward rules provide guidance for integrating the foreign and U.S.-governed aspects (*see, e.g.,* sections 902(a), 902(b)(2), 1.904-6(b)).

of $100, on which A pays Country X tax of $30. As explained in Part IV above, under current law, M would be eligible to claim a credit for $30 of Country X tax under section 901 without having to include the related $100 tax base in income. In contrast, under the proposal, section 1.901-2(f)(3) would apply to this situation because (i) it would no longer be a condition to its application that the related persons be jointly and severally liable for the foreign tax (proposal "a" above), and (ii) the Country X tax would be treated as "imposed on the combined income of two or more related persons" because (x) each of A and B is treated as a related person notwithstanding that B is a tax-transparent entity under Country X law and (y) the $100 tax base is income of A for Country X purposes but of B for U.S. tax purposes (see proposals "b" and "c"). Under proposal "e," the $100 tax base would be treated as belonging to B (since it earned the income under U.S. tax principles), and therefore Country X is considered to impose legal liability on B for the $30 of tax attributable to such tax base. M would be eligible to claim a foreign tax credit in respect of the $30 of Country X tax under section 902 when and to the extent that it receives a dividend of the related earnings and profits of B.

A similar result would obtain under the proposal if A did not exist, M owned B directly, and Country X imposed the tax directly on M, since the Country X tax would be treated as "imposed on the combined income of two or more related persons" (M and B) under proposals "b," "c" and "d."

In the case of an accreting, no-current-coupon hybrid security that is treated as debt for foreign tax purposes but as equity for U.S. tax purposes, such as that described at the end of Part IV above, as a result of proposal "e" the earnings attributable to the yield on the security and the foreign tax that is imposed thereon by the holder's country would be attributed to the obligor for purposes of applying sections 901 and/or 902, since for U.S tax purposes the



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Proposal "e" is intended to ensure that the tax and related tax base are matched in the same entity (whether or not tax-transparent) that is treated as the taxpayer, and thus as having the related earnings, for U.S. tax purposes. Accordingly, in the case of a reverse hybrid entity, the tax and related tax base would both be attributed to that entity rather than to its member(s), even if foreign tax law were to attribute the tax base directly to, and impose tax on, its member(s). Stated differently, proposal "e" is simply a "situs" rule: While the amounts of the foreign tax and the related tax base would continue to be determined under foreign law, proposal "e" would apply U.S. tax principles in a manner consistent with the principles underlying the foreign tax credit rules to determine the respective portions thereof that belong to each entity. The general foreign tax credit rules would then operate in respect of the amounts of tax and tax base attributed to each such entity under this special rule.[51]

To illustrate, assume that U.S. multinational M owns a Country X hybrid entity (A), which in turn owns a Country X reverse hybrid operating subsidiary (B). B has net profits

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[51] Thus, for example, once the tax base and related foreign tax are attributed to the proper entity under proposal "e," section 1.904-6(a)(iv) would apply in respect of base or timing differences in the amounts determined for U.S. and foreign tax purposes.

Use of U.S. tax principles to determine the entity to which creditable foreign taxes and the related tax base belong in the context of section 1.901-2(f)(3) does not appear to raise particular issues or to be inconsistent with other aspects of the foreign tax credit rules. For example, while foreign tax principles generally determine the identity and amount of the relevant foreign tax base and the amount of foreign taxes attributable thereto (*see* section 1.904-6(a)), U.S. tax rules are taken into account in allocating certain expenses to the gross income in the foreign tax base (*see id.*). Other aspects of the foreign tax credit computation also are governed by U.S. tax rules (including, most significantly, earnings and profits pools under section 902 and separate section 904 income categories), and relatively straightforward rules provide guidance for integrating the foreign and U.S.-governed aspects (*see, e.g.,* sections 902(a), 902(b)(2), 1.904-6(b)).

of $100, on which A pays Country X tax of $30. As explained in Part IV above, under current law, M would be eligible to claim a credit for $30 of Country X tax under section 901 without having to include the related $100 tax base in income. In contrast, under the proposal, section 1.901-2(f)(3) would apply to this situation because (i) it would no longer be a condition to its application that the related persons be jointly and severally liable for the foreign tax (proposal "a" above), and (ii) the Country X tax would be treated as "imposed on the combined income of two or more related persons" because (x) each of A and B is treated as a related person notwithstanding that B is a tax-transparent entity under Country X law and (y) the $100 tax base is income of A for Country X purposes but of B for U.S. tax purposes (see proposals "b" and "c"). Under proposal "e," the $100 tax base would be treated as belonging to B (since it earned the income under U.S. tax principles), and therefore Country X is considered to impose legal liability on B for the $30 of tax attributable to such tax base. M would be eligible to claim a foreign tax credit in respect of the $30 of Country X tax under section 902 when and to the extent that it receives a dividend of the related earnings and profits of B.

A similar result would obtain under the proposal if A did not exist, M owned B directly, and Country X imposed the tax directly on M, since the Country X tax would be treated as "imposed on the combined income of two or more related persons" (M and B) under proposals "b," "c" and "d."

In the case of an accreting, no-current-coupon hybrid security that is treated as debt for foreign tax purposes but as equity for U.S. tax purposes, such as that described at the end of Part IV above, as a result of proposal "e" the earnings attributable to the yield on the security and the foreign tax that is imposed thereon by the holder's country would be attributed to the obligor for purposes of applying sections 901 and/or 902, since for U.S tax purposes the

obligor has the tax base to which the yield on the security that is subject to the foreign tax is attributable.[52] However, proposal "e" must be applied in a manner consistent with the principles underlying the foreign tax credit rules. Thus, if foreign corporation B were to issue a security to related (U.S. or foreign) corporation A that is treated as equity for foreign tax purposes but as debt for U.S. tax purposes, the foreign tax that is imposed on B would not be attributed under proposal "e" to A notwithstanding that the related tax base belongs to A for U.S. tax purposes because, under the principles underlying the foreign tax credit rules, the holder of a debt instrument (A) is not eligible for a foreign tax credit in respect of foreign taxes paid by the obligor (B).[53]

In substance, where tax is imposed on the combined income of two or more related persons (as such terms are broadly defined under the proposal), the foregoing proposed changes to the regulation would apply uniform and neutral rules to attribute to each related person, and to consider such person to have legal liability under foreign law in respect of, "the

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52 A similar result would occur in the case of other hybrid arrangements between related persons, such as a transaction that is treated as a lease or license for foreign tax purposes but as an equity investment by one related person in another for U.S. tax purposes.

53 We recommend that amended regulations contain examples illustrating the application of these proposals to various types of hybrid arrangements.

These proposals are intended to apply to no-current-coupon hybrid securities and other hybrid arrangements only where the parties are related and the arrangement results in a separation of creditable foreign tax from the related tax base, and only for purposes of matching the tax and tax base for purposes of sections 901 and 902. Other issues raised by hybrid arrangements, in these and other contexts, are beyond the scope of this report and the proposals made herein.

Thus, for example, this report does not address the questions raised by the second class of transactions described in Notice 98-5 (*i.e.*, investment structures utilizing hybrid securities to enable both a U.S. taxpayer and a foreign counterparty to claim a credit for the same taxes incurred by an investment vehicle) or issues remaining outstanding under temporary regulation section 1.704-1T(b)(4)(xi) (*e.g.*, which partner should be eligible to claim a credit in respect of hybrid securities issued by a partnership, such as preferred payments that are deductible for foreign tax purposes, or guaranteed payments). For a discussion of the latter set of issues, *see* the Partnership Foreign Tax Credit Report, *supra*, at Part VII. The proposals contained herein would simply match the creditable tax with the tax base in the relevant situations; how those credits are to be taken into account and by which direct or indirect members of the entity would be determined under other rules, including temporary regulation section 1.704-1T(b)(4)(xi) and any other guidance that may be issued in the future.

amount of the foreign income tax that is attributable to its portion of the base of tax, regardless of which person actually pays the tax" and regardless of the tax characterization of the various entities or interests therein under foreign or U.S. law. The proposed changes would apply for purposes of both the direct credit under section 901 and the indirect credit under section 902. In both cases, in the first instance, amended section 1.901-2(f)(3) would determine the amount of creditable foreign tax that each entity within the combined group (as broadly defined under the proposal) would be treated as having paid or accrued, essentially by allocating to that entity the amount of tax that is attributable to the portion of the tax base that is treated as belonging to that entity under U.S. tax principles in a manner consistent with the principles underlying the foreign tax credit rules. Then, the applicable rules under the relevant provision (section 901 or 902) would determine the timing and amount of, and any limitation on, the credit. Because each tax-transparent entity (including a disregarded entity), whether under U.S. or foreign law, would be treated separately under amended section 1.901-2(f)(3) and because the attribution of the tax base among entities (and therefore the attribution of the tax attributable thereto) would be done under U.S. tax principles in a manner consistent with the principles underlying the foreign tax credit rules, a creditable foreign tax that is allocated under that provision to such a tax-transparent entity that is a reverse hybrid would be matched with the income of that entity and could be claimed as a credit by the member(s) of that entity only when allowed under section 902. As noted above, if the entity that has paid the tax is a partnership for U.S. federal income tax purposes, its creditable foreign tax would be apportioned among its partners in accordance with new temporary regulation section 1.704-1T(b)(4)(xi).

As noted, the proposed changes would not apply to taxes that are imposed under an integrated tax system, where the shareholder is not itself subject to the relevant foreign

country corporate level tax but takes such tax into account in determining its own tax liability to that foreign country. Thus, section 1.901-2(f)(3), as revised, would not apply to a *Biddle*-type situation, where a U.S. shareholder's foreign tax liability (or eligibility for a refund) in respect of dividends received from the foreign corporation takes account of taxes paid by the corporation in respect of the earnings underlying the dividend. Similarly, the revised provision would not affect the application of section 902 where a foreign corporation that receives an actual or constructive dividend from a subsidiary (whether organized in the same country or in another country) is eligible for an indirect credit under foreign law – rather than to the rules of a consolidated tax regime – in respect of income taxes paid by the subsidiary on the earnings that were distributed. In addition, the revised provision generally would not apply to a group relief system such as in the U.K. (where each company computes its liability on a stand-alone basis but companies within the group can surrender losses to affiliates).[54] These different tax systems are sufficiently distinguishable from the situations that are covered by the proposed changes, and any issues that might be presented under these systems from the potential separation between creditable foreign taxes and the related income should be addressed separately.

In arriving at the recommendations set forth above, we considered an alternative approach that, instead of removing the "joint and several liability" condition, would expand section 1.901-2(f)(3) to provide that where joint and several liability does not exist, a taxpayer cannot claim a credit for foreign taxes until it includes in income an amount equal to the U.S. equivalent of the portion of the base of the tax that is associated with the credit.[55] This

[54] However, even in the case of an integrated or group relief system, the proposed changes would apply to the extent that a reverse hybrid structure (or a no-current-coupon hybrid security) is utilized to separate creditable foreign taxes from the related income.

[55] This alternative approach could be combined with an expansion of the "joint and several" concept in the regulation along the lines mentioned in Part V.B above, so that persons would be treated as "jointly and severally liable for the income tax under foreign law" even where one or more of such persons is only

alternative arguably is more consistent with the historic articulation of the technical taxpayer rule since it merely imposes a restriction on the timing of a credit but does not attribute the creditable foreign tax from the entity that paid the tax to the related entity that earned the income. In our view, however, this alternative is decidedly less attractive because it would necessitate the development of potentially complex rules for continuously tracking the tax base that is associated with the credit in order to determine when the taxpayer includes it in income and therefore is eligible to claim the credit. We see no reason to resort to that alternative because, as discussed above, we believe that the approach recommended herein can be reconciled with the technical taxpayer rule and in any event is supported by regulatory authority and policy considerations.

VIII. TRANSITION RULES.

In terms of transition rules, we recommend that the proposed amendments should apply prospectively, as of the beginning of the first taxable year of the relevant foreign entity after their effective date. While we see no reason to grandfather existing arrangements, we do feel that it would be disruptive for taxpayer planning and tax administration by the IRS to modify the rules in the middle of a taxable year. In general we think it appropriate for this purpose to look to the taxable year of the foreign entity that is treated as earning the relevant tax base for U.S. tax purposes, since that is the entity that would also be treated as paying the related foreign tax under the proposed amendments.

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secondarily liable, is liable only if a primary obligor does not pay the tax, is relieved of liability if (or immediately before) another person pays the tax, is liable under contract (such as under a tax sharing agreement) and/or has several but not joint liability (even for only a portion of the tax).

In order to avoid a double benefit to taxpayers, taxes that were taken into account under sections 901 or 902 during a previous taxable year should be disregarded for purposes of post-effective date taxable years.