



Securities Industry Association

1425 K Street, NW • Washington, DC 20005-3500 (202) 216-2000 • Fax (202) 216-2119 •
www.sia.com, info@sia.com

October 5, 2006

By Regular Mail and Electronic Mail

CC:PA:LPD:PR (REG-124152-06)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Dear Sir/Madam:

On behalf of the Securities Industry Association, I am pleased to submit comments on the new proposed regulations addressing the definition of taxpayer for purposes of Section 901 and related matters.

Thank you for your consideration of our views. Please do not hesitate to contact me (at 202-216-2031 or pmcclanahan@sia.com) or Edward Kleinbard of Cleary Gottlieb Steen & Hamilton LLP, SIA's outside counsel on this matter (at 212-225-2480 or ekleinbard@cgsh.com), if SIA can be helpful in any way as you proceed with your work in this area.

Sincerely,

Patricia McClanahan
Vice President and Director for Tax Policy
Securities Industry Association

Cc: Hal Hicks
Steve Musher
Barbara Felker
John Harrington
Bethany Ingwalson

Comments in accompanying document



Securities Industry Association

1425 K Street, NW • Washington, DC 20005-3500 (202) 216-2000 • Fax (202) 216-2119 •
www.sia.com, info@sia.com

October 5, 2006

**SIA SUBMISSION IN RESPONSE TO NOTICE OF PROPOSED RULEMAKING
REGARDING THE DEFINITION OF “TAXPAYER” UNDER SECTION 901**

I. INTRODUCTION.

A. The Proposed Regulations.

On August 4, 2006, the Internal Revenue Service published a Notice of Proposed Rulemaking with respect to a regulation project (REG-124152-06) titled “Definition of Taxpayer for Purposes of Section 901 and Related Matters.”¹ The Notice of Proposed Rulemaking would amend Treas. Reg. § 1.901-2(f)² and make certain other conforming changes (collectively, the “Proposed Regulations”).

The Securities Industry Association (the “SIA”)³ is pleased to submit comments with respect to the Proposed Regulations. Our comments focus primarily on those portions of

¹ 71 Federal Register 44240 (August 4, 2006).

² Unless indicated otherwise, all section references herein are to the Internal Revenue Code of 1986, as amended (the “Code”), or to the Treasury regulations promulgated thereunder.

³ The Securities Industry Association brings together the shared interests of almost 600 securities firms to accomplish common goals. SIA’s primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2005, the industry generated an estimated \$322.4 billion in domestic revenue and \$474 billion in global revenues. (More information about SIA is available at: www.sia.com (<http://www.sia.com/>)).

the Proposed Regulations that affect agency or nominee arrangements (Prop. Reg. § 1.901-2(f)(1)(i) and Examples 2 and 3),⁴ as well as the implications of our proposed revisions to such provisions for investors that sell securities between coupon payment dates.

The Proposed Regulations generally would revise the rules of existing Treas. Reg. § 1.901-2 for determining when a U.S. taxpayer will be treated as having “paid” an otherwise creditable foreign tax, so as to enable that U.S. taxpayer to claim a foreign tax credit in respect thereof. The Proposed Regulations would retain current Treas. Reg. § 1.901-2’s basic principle of the “legal liability” or “technical taxpayer” rule, pursuant to which the person upon whom foreign law imposes legal liability for a tax is entitled to claim the associated credit, regardless of whether such person actually bears the economic burden of the tax.⁵ The fundamental policy rationale behind the technical taxpayer rule is “the desire to have a simple, straightforward rule that can be readily administered by taxpayers and the Internal Revenue Service and that avoids the difficult and often nebulous inquiries as to where the incidence of tax falls as an economic matter.”⁶ By retaining the general framework of the technical taxpayer rule, the Proposed Regulations seek to preserve the benefits of simplicity, certainty and administrability that are reflected in current law and administrative practice.⁷

The Proposed Regulations would revise and clarify the application of the technical taxpayer rule to foreign consolidated groups, “reverse hybrid” entities (*i.e.*, entities that are treated as corporations for U.S. tax purposes, but as fiscally transparent entities for foreign tax law purposes), and “hybrid” entities (*i.e.*, entities that are treated as partnerships or

⁴ Our references in this submission to Examples 2, 3, and 4 are to those examples in Prop. Reg. § 1.901-2(f)(6).

⁵ Treas. Reg. §§ 1.901-2(f)(1) and (2).

⁶ 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* (Apr. 4, 2005), at 7.

⁷ *See id.* at 28.

disregarded entities for U.S. tax purposes, but as corporations for foreign tax purposes). We think that a guiding principle of the Proposed Regulations in this regard is to require, whenever possible, the matching of *income* (as determined under U.S. tax principles, both as to timing and as to location) with the associated *foreign tax* (and, therefore, the foreign tax credit) imposed on such income.

At the same time, the Proposed Regulations would “clarify” (to quote the Preamble) existing law by providing that, in general, “foreign law is considered to impose legal liability for tax on income on the person who is required to take the income into account for foreign income tax purposes.”⁸ The fundamental thesis of our submission is that, if implemented, this “clarification” in fact will constitute a *change in law*. Moreover, the Proposed Regulations will produce results in many common fact patterns that are completely inconsistent with the principle of aligning creditable foreign taxes and the tax base to which such credits relate, will lead in those fact patterns to the systematic disallowance of foreign tax credits for withholding taxes, and will be profoundly disruptive to the public capital markets.

B. Summary of Our Submission and Recommendations.

We believe that the Proposed Regulations’ modernization of the technical taxpayer rule to address foreign consolidated groups, reverse hybrid entities, and hybrid entities represents an important and welcome development, because it elucidates the technical taxpayer rule in a manner that more closely aligns creditable foreign taxes and the tax base to which those credits relate. We applaud the Internal Revenue Service and the Treasury Department for proposing these revisions to the foreign tax credit regulations while preserving the essential elements of the technical taxpayer rule.

On the other hand, we have very substantial concerns regarding the application of the Proposed Regulations to agency or nominee arrangements. We believe that, as applied to

⁸ Prop. Reg. § 1.901-2(f)(1)(i).

such arrangements, the Proposed Regulations (i) are inconsistent with commercial practice and are not administratively feasible, (ii) would lead in practice to the systematic disallowance of foreign tax credits for withholding taxes actually suffered by U.S. owners, in circumstances where Congress expected those credits to be allowable, (iii) are not required by the caselaw that developed the technical taxpayer rule or that addresses foreign withholding taxes, (iv) are inconsistent with pertinent authorities regarding agency or nominee arrangements, and (v) are not a desirable means of addressing policy concerns.

In particular, the results reached by the Proposed Regulations in respect of agency or nominee arrangements appear to us to be inconsistent with the Internal Revenue Service's own published guidance on the creditability of withholding taxes — in particular, Revenue Ruling 65-218⁹ (holding that a taxpayer may claim foreign tax credits in respect of withholding taxes incurred from investing in American Depositary Receipts) and Revenue Ruling 72-514¹⁰ (holding that a taxpayer may claim foreign tax credits in respect of withholding taxes incurred on a loan held through an undisclosed agent). Moreover, Congress in recent years has revised the Code (through the enactment of sections 901(k) and 901(l)) to address specific concerns about the circumstances in which taxpayers may claim foreign tax credits in respect of withholding taxes. We are not aware of any suggestion in the legislative history to those Code sections of the possible existence of the rule recommended by the Proposed Regulations for nominee arrangements, and that limitation was not part of the new restrictions that Congress in fact enacted.

We therefore recommend that the Proposed Regulations be amended by:

- a. Revising Prop. Reg. § 1.901-2(f)(1)(i) to provide that “Income tax (within the meaning of paragraphs (a) through (c) of this section) is considered paid for U.S. income tax purposes by the person on whom foreign law imposes legal

⁹ 1965-2 C.B. 566, discussed *infra*, text at note 19.

¹⁰ 1972-2 C.B. 440, discussed *infra*, text at note 40.

liability for such tax. In general, for purposes of this section, the person on whom foreign law imposes legal liability for such tax shall be determined by first determining the person who is required to take the income into account for foreign income tax purposes (paragraph (f)(4) of this section reserves with respect to certain related party hybrid payments) (the “foreign taxable person”), and then determining under U.S. tax principles who is the owner of the income required to be included by the foreign taxable person at the time the tax is imposed under foreign law. The tax is considered to be paid by the owner of the income, as determined under U.S. tax principles, at the time the tax is imposed under foreign law. This rule applies even if under foreign law another person is obligated to remit the tax”;

- b. Deleting the following sentence from Example 2: “Country X law also recognizes the nominee or agency arrangement and, thus, considers C to be the beneficial owner of the interest income.”; and
- c. Revising the result in Example 3 to provide that “Under paragraph (f)(1)(ii) of this section, B is considered the foreign taxable person with respect to the interest income paid by C. A is considered legally liable for the country X tax because A is the owner of that interest income for U.S. tax purposes, and therefore A is considered for U.S. tax purposes to have paid the tax. The result would be different if the transaction had the effect of transferring ownership of the bond to B for U.S. income tax purposes.”

II. THE CONFLICT BETWEEN THE PROPOSED REGULATIONS AND THE CAPITAL MARKETS.

A. Examples 2 Through 4.

The Proposed Regulations contain two examples that illustrate how its revision of the “legal liability” rule to look to “the person who is required to take the income into account for foreign income tax purposes” would apply with respect to withholding taxes imposed on securities held through agency or nominee arrangements. Example 2 involves a withholding tax on interest in respect of a loan that is held through a nominee or agency arrangement. The foreign country in which the debtor of the loan in question is domiciled (for convenience, “Freedonia”) recognizes the agency arrangement, and thus considers the U.S. person that is the owner of the loan (and therefore of the income derived therefrom) for U.S. tax purposes also to be the beneficial owner of the interest income for Freedonian purposes. The example effectively

concludes that the U.S. owner of the security may claim the Freedomian withholding tax as a foreign tax credit (assuming, of course, that other relevant statutory provisions are satisfied).¹¹

Example 3 presents essentially the same facts as Example 2, except that in Example 3 Freedomia recognizes the holder of bare legal title as the owner of the relevant security for Freedomian tax purposes. More specifically, in Example 3 a U.S. person owns a bond issued by a resident of Freedomia. The U.S. person borrows money secured by that bond. The form of the borrowing is a sale-repurchase, or “repo,” agreement, under which the U.S. person “sells” the bond to a financial institution and simultaneously agrees to repurchase the bond at a fixed date in the future at a price that reflects the value of money return to the counterparty.¹² (A “repo” is the most common form by which participants in the U.S. capital markets borrow money against the collateral of securities that they own.) For U.S. tax purposes, the U.S. person remains the owner of the Freedomian bond and the associated income.¹³ For

¹¹ Example 2 in the Proposed Regulations is substantially similar to Example 2 in current Treas. Reg. § 1.901-2(f), with one significant difference—in the Proposed Regulations, this example contains the additional statement that “Country X law also recognizes the nominee or agency arrangement and, thus, considers C to be the beneficial owner of the interest income.”

¹² The facts of Example 3 contemplate a five-year sale-repurchase agreement. In fact, most commercial repos are overnight (or day-to-day) arrangements, but the analysis in Example 3 does not appear on its face to turn on this fact. The five-year term of the repo in the example, however, is consistent with the view that what might have motivated the drafters of the Proposed Regulations in reaching the conclusions that they did on nominee or agency arrangements was a concern with tax arbitrage transactions (where, for example, the lender in the repo case of Example 3 itself obtains a foreign tax credit in *its* jurisdiction for the Freedomian withholding tax imposed on interest payments on the underlying bond, and presumptively shares the benefit of that tax credit with the U.S. borrower through the pricing of the interest charged to the U.S. person under the repo). We return to the question of whether these technical taxpayer regulations are the appropriate place to address arbitrage transactions in Section III.C.2, below.

¹³ See Rev. Rul. 74-27, 1974-1 C.B. 24; Rev. Rul. 77-59, 1977-1 C.B. 196; Rev. Rul. 79-108, 1979-1 C.B. 75; Rev. Rul. 79-195, 1979-1 C.B. 177. The U.S. Supreme Court cited the Service’s position in *Nebraska Dept. of Revenue v. Loewenstein*, 513 U.S. 123, 128 n. 3 (1994), in holding that repos are collateralized lending agreements for purposes of characterizing payments with respect to such transactions for state tax purposes. See also *First American Nat’l Bank of Nashville v. United States*, 467 F.2d 1098 (6th Cir. 1972);

Freedonian tax purposes, however, the lender to the U.S. owner of the Freedonian bond—that is, the party that “reverses in” the bond—is treated as the owner of the bond, because that institution has legal title to the bond during the term of the repo.

Example 3 concludes that the U.S. owner of the Freedonian bond may *not* claim a foreign tax credit in respect of the withholding tax imposed on interest payments on that bond, because Freedonia believes that the secured lender to the U.S. taxpayer is the owner of the bond, by virtue of its holding bare legal title. Example 3 reaches this result despite the fact that the U.S. owner (i) bears all economic risk with respect to the underlying Freedonian bond, (ii) must include all income from the bond on its U.S. federal income tax return, and (iii) in practice is likely to be the party actually bearing the economic burden of the withholding tax.

The result required by Example 3 would undercut the larger guiding principle of the Proposed Regulations by affirmatively *separating* income (as determined under U.S. tax principles) from the foreign tax (and therefore the foreign tax credit) imposed on that income. More dramatically, where the secured lender to the U.S. owner of the Freedonian bond is itself a U.S. institution (or an institution in a country that follows similar principles of beneficial ownership), as often will be the case, the result required by Example 3 would amount in practice to a *disallowance* to *any* person of the foreign tax credit associated with the withholding tax suffered by the U.S. owner.¹⁴

We believe that this result is inconsistent with the purpose of the foreign tax credit rules generally, with capital markets practice (as described in the next section of this letter), and

Union Planters Nat’l Bank of Memphis v. United States, 426 F.2d 115 (6th Cir.), cert. denied, 400 U.S. 827 (1970); *American Nat’l Bank of Austin v. United States*, 421 F.2d 442 (5th Cir.), cert. denied, 400 U.S. 819 (1970); PLR 200207003 (October 23, 2001).

¹⁴ A secured lender that is a U.S. institution cannot claim a foreign tax credit in respect of withholding taxes imposed on a security that it does not own under U.S. tax principles, by virtue, at a minimum, of section 901(l). We believe that the same result applied under common law principles in years prior to the effective date of section 901(l), and we further believe that market practice was consistent with this position.

with the adoption by Congress of sections 901(k) and 901(l). The latter two Code provisions begin with the premise that (in the absence of any special rule) the foreign tax credit is available for withholding taxes incurred in respect of income properly includible by a U.S. person, and then impose a set of “at risk” rules to ensure that the U.S. taxpayer in fact is the meaningful and substantive owner (in a U.S. tax sense) for a significant period of time of the income stream that gives rise to that withholding tax.¹⁵

We are not aware of any suggestion in the legislative history of those two Code sections, or in the statutory tests themselves, that foreign law principles of ownership have any relevance to this analysis. The entire thrust of sections 901(k) and 901(l) thus is to require a reasonable (but not perfect) *matching* of income and credits. The result reached in Example 3, by contrast, points in the opposite direction, and contemplates not only the routine separation of credits from income, but also, as a practical matter, the systematic disallowance of those orphaned credits.

Example 4 of the Proposed Regulations deals with a different aspect of the application of the technical taxpayer rule to withholding taxes. Whereas Examples 2 and 3 consider the availability of credits for withholding taxes imposed on payments to agents or nominees, Example 4 involves the availability of credits for withholding taxes imposed on a taxpayer that holds a security for less than a full coupon accrual period. In this example, a Freedonian bond pays interest annually on December 31st; that interest income, in turn, is subject to withholding tax in the hands of U.S. investors. U.S. taxpayer A sells the bond to U.S. taxpayer B halfway through the calendar year. For U.S. federal income tax purposes, A recognizes the interest income that accrues for the first half of the year, even though A receives

¹⁵ Sections 901(k) and 901(l) generally deny a credit for withholding taxes unless the taxpayer satisfies a minimum 16-day holding period and is not “under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.” IRC §§ 901(k)(1)(A)(ii) and 901(l)(1)(B).

that interest from B through A's secondary market sale, and not from the Freedomian issuer.¹⁶

Because B owns the bond on December 31st, Example 4 treats B as legally liable for (and as entitled to claim foreign tax credits with respect to) withholding taxes imposed upon the entire amount of interest paid that year.

The result reached in Example 4, like that reached in Example 3, can be said to result in a separation of the income earned on the Freedomian bond from the associated foreign tax credit, but for a completely different reason. Example 3 reaches that result by virtue of looking to Freedomian rather than U.S. law to identify the specific taxpayer that is the owner of the income on which the Freedomian tax is imposed, while in Example 4 the choice of law is not relevant; what matters in the latter case is that, even when viewed entirely under U.S. tax principles, the relevant tax is imposed on the *payment* of cash interest, not on the accrual of income. In Example 4, only B is the owner of the security when the payment is made and the associated tax liability incurred.

B. Capital Markets Practice.

The universal capital markets practice today is inconsistent with the result reached in Example 3, but it is consistent with the result reached (if perhaps not all the reasoning implicit in) Example 4. The capital markets understanding today is that the appropriate manner in which to apply the technical taxpayer rule to nominee or agency arrangements, consistent with the authorities and policies described in Part III of this submission, is to look to *foreign* law to determine the nature of the tax in question—that is, is the tax in fact one that is imposed on owners of a particular security, or instead on the issuer of that security?¹⁷ Having determined that the tax in question is a tax on investors under foreign law principles, the universal market practice is to associate the resulting tax (typically, a withholding tax) with the owner of the

¹⁶ Treas. Reg. § 1.61-7(d).

¹⁷ Cf. *Biddle v. Commissioner*, 302 U.S. 573 (1938), discussed in Section III.A, *infra*.

income for U.S. tax purposes. Market practice thus accords with the larger principle of the Proposed Regulations, which is to accomplish the matching of income and the associated foreign tax credit.

Market practice today for the allocation of withholding taxes in the case of sales of securities between coupon payment dates follows the results reached in Example 4, for two reasons. First, a foreign withholding tax by definition is imposed on the *payment* of interest or a dividend, and even under entirely U.S. tax principles there can be only one owner of the security on the date in which the tax liability accrues (the date of payment).¹⁸ As applied to interest (but not dividend) income, this analysis admittedly leads to a separation of income and associated foreign withholding tax for the inter-coupon payment period. This divergence from the ideal of matching income with foreign tax credits leads to the second reason for current market practice: this result is the only one that is administrable, in that in many cases only the owner of a security at the time that withholding tax is imposed will be able to demonstrate to the Internal Revenue Service on examination that the withholding tax in fact has been suffered (through the production of tax receipts, for example).

Congress recognized the practical reality that it is impossible to avoid the separation of income from the associated foreign tax credit in the narrow circumstance of the sale of a security between coupon payment dates by adopting sections 901(k) and 901(l). As described above, these Code sections can be understood as requiring that a U.S. person be the beneficial owner for a meaningful period of time of the income stream from a security in order to claim a withholding tax with respect thereto as a foreign tax credit. The regime contemplated by Congress, and reflected by Example 4, thus makes a virtue of necessity.

¹⁸ In addition, as a technical matter, dividend income (in contrast to interest income) does not accrue simply by the passage of time; instead, an investor has no right to dividend income unless and until the issuer's Board of Directors declares the dividend. As a result, a seller of stock in the secondary markets does not allocate her sales proceeds between "accrued" dividends and corpus.

C. Beneficial Ownership and Legal Title in the Capital Markets.

The new requirement imposed by the Proposed Regulations—that a U.S. taxpayer may not claim a credit with respect to a foreign tax unless such person must take the associated income into account for foreign income tax purposes—is completely inconsistent with capital markets practice today, because it is the *norm* in the capital markets for legal title to be separated from beneficial ownership. This section offers a series of examples that demonstrate just how pervasive this practice is.

1. American Depositary Receipt (“ADR”) and Global Depositary Receipt (“GDR”) Programs. Most shares of foreign issuers that are traded in the public U.S. capital markets are held through ADR or GDR programs. Pursuant to these programs, U.S. investors do not directly hold title to shares of a foreign issuer. Rather, the issuer’s shares are acquired by a “depository” that serves as a custodian or financial intermediary; in turn, the depository issues receipts (the ADRs or GDRs) that represent a designated number of the issuer’s shares. These receipts are listed and traded on stock exchanges, while the shares represented by such ADRs or GDRs remain in the depository’s custody.

ADR holders can vote the underlying shares, and receive any dividends paid on those shares; if the payment is in a foreign currency, the depository ordinarily converts those amounts into U.S. dollars for the convenience of ADR holders. Although the depository is the nominal owner of the issuer’s stock, ADR holders are the beneficial owners thereof for all U.S. tax purposes. The Internal Revenue Service therefore has ruled that owners of ADRs or GDRs are entitled to claim the foreign tax credit on withholding taxes suffered on the underlying shares—without any duty of inquiry into legal principles of agency under the laws of the issuer of those securities.¹⁹

¹⁹ Revenue Ruling 65-218, 1965-2 C.B. 566.

2. Securities Held in “Street Name” Through Clearing Organizations. As a general matter, when broker-dealers acquire securities in the U.S. public capital markets (whether for their own account or for the account of customers), they neither obtain physical certificates nor cause the securities to be registered in their own names. Instead, a broker-dealer typically receives or transfers securities through electronic accounts that it maintains with a clearing organization, such as the Depository Trust Company (“DTC”); from the perspective of an issuer, the clearing organization (or its nominee) is the owner of record of those securities. When, for example, a broker-dealer buys a security for a customer, the clearing organization will credit the broker’s account, and the broker in turn will credit its customer’s account; the entire transaction takes place electronically on the books of the clearing organization and the broker-dealer. These book entries are opaque to the issuer, which sees only the clearing organization (or its nominee) as the holder of record of the securities.

3. Bank Loan Participations. Bank loans are regularly traded in the secondary markets. For a variety of customer relationship and documentation reasons, those sales often take the form of sales of “participation” interests in the loan; the participation is designed to transfer beneficial ownership of a portion of the loan, but to leave legal title with the original lender.

4. Secured Loans. Securities dealers (and institutional customers) routinely use securities that they own as collateral, either for borrowing money or for other financial transactions (such as borrowing different securities). A money lender can obtain a perfected security interest in securities under relevant commercial law by taking legal title thereto, and many secured loans therefore are structured to shift legal title to the collateral to the lender. As a result, in many cases where an institution uses its securities inventories (or investment portfolio) as collateral, there is a separation of the *ownership* of those securities (in the tax sense) from the *legal title* thereto. Securities dealers and similar financial institutions often have debt-to-equity

ratios of 20:1 or 30:1, which is possible only because they systematically exploit the very liquid secured loan markets for publicly traded securities. Sale-repurchase agreements (as described earlier) are the best-known example of these sorts of liquid markets for loans collateralized by publicly traded securities, in which legal title to a security is transferred to a lender to enable the lender to obtain a perfected security interest.

5. Trust Arrangements. Trusts generally involve the establishment of a fiduciary relationship among a grantor, a trustee, and a beneficiary. For U.S. tax purposes, there are three types of non-business trust arrangements. A grantor trust is a trust with respect to which the grantor (or other owner) retains the power to control or direct the trust's income or assets; a simple trust is a trust that is not treated as a grantor trust and that is required to distribute all "income" (which, for this purpose, may or may not include capital gains) annually; and a complex trust is any other trust. A non-business trust is not a hybrid entity, reverse hybrid entity, or disregarded entity for purposes of the Proposed Regulations.²⁰ Beneficial ownership of assets transferred to a grantor trust generally remains with the grantor for U.S. tax purposes. In contrast, in both a simple trust and a complex trust, the trust itself is the owner of the trust assets, but pursuant to section 901(b)(5) either a beneficiary or (in the case of a complex trust) the trust itself may be able to claim a foreign tax credit, because the credit effectively follows the distribution of the income to which that credit relates.²¹

Under the Proposed Regulations, U.S. taxpayers, brokers, and other agents or nominees would be required to investigate the treatment of each of the foregoing types of

²⁰ A "reverse hybrid" entity for purposes of the Proposed Regulations is a corporation for U.S. tax purposes. Prop. Reg. § 1.901-2(f)(2)(iii). A "hybrid" entity for these purposes is a partnership for U.S. tax purposes, Prop. Reg. § 1.901-2(f)(3)(i), or a disregarded entity within the meaning of Treas. Reg. § 301.7701-2(c)(2)(i), Prop. Reg. § 1.901-2(f)(3)(ii). Treas. Reg. § 301.7701-2(c)(2)(i) in turn defines a disregarded entity as a *business* entity that has a single owner and is not a corporation.

²¹ Cf. PLR 9313018 (Apr. 2, 1993); FSA 200105001 (Nov. 3, 2000).

ownership arrangements (as well as others not listed above) under the laws of virtually every foreign country that imposes a potentially creditable foreign withholding tax—and to reach agreement with the Internal Revenue Service with respect to such treatment—to determine whether a U.S. taxpayer is the person required to take the associated income into account under foreign law. As demonstrated by recent caselaw,²² it is not always easy for the Internal Revenue Service or the courts (or, for that matter, for U.S. brokers or other intermediaries) to determine what foreign law actually provides—particularly when the legal relationship at issue (*e.g.*, a trust) has no direct analogue under that foreign law. This herculean undertaking would impose a commercially unreasonable burden on customers and financial services firms and would markedly reduce the efficiency of the capital markets.

One example can illustrate the complexity of the inquiry into foreign law that the Proposed Regulations contemplate. Freedonia does not have a direct analogue to U.S. non-business trusts. Freedonia imposes withholding tax on dividends and interest on securities held by a U.S. non-business trust. In determining who is the taxpayer under Freedonian law, must U.S. taxpayers and the Internal Revenue Service determine whether it matters under Freedonian law that the trust might be a grantor trust, a simple trust, or a complex trust, or whether it matters to Freedonian counsel that the income in question might be retained by the trust (in which case the trust obtains the foreign tax credit for U.S. purposes) or instead might be distributed to beneficiaries (in which case U.S. law would treat the beneficiaries as the taxpayers)? How will taxpayers and the Internal Revenue Service determine (and agree on) these questions of Freedonian law, which may or may not even have been considered by a Freedonian court? And why should the United States disallow foreign tax credits in some cases, but not in others, based solely on whether the foreign jurisdiction has a substantive law of trusts (and tax rules with respect to the characteristics of trusts) that precisely mirror ours?

²² See *Guardian Industries Corp. v. U.S.*, 65 Fed. Cl. 50 (Fed. Cl. 2005).

This result is particularly paradoxical given that none of this inquiry is required for an actual *business* entity—for example, a limited liability company—if that limited liability company constitutes a disregarded entity, because the Proposed Regulations contemplate that the income and tax credits of a disregarded entity *always* flow through to its owner.²³ As a result, a taxpayer that cannot directly “repo” a Freedomian bond under the rule described in Example 3 might choose to hold that bond through a business entity that is a separate juridical entity for all Freedomian and U.S. purposes *other* than U.S. tax law, but that is nonetheless a disregarded entity for U.S. tax purposes. The U.S. owner then could “repo” the ownership interests of the disregarded entity, rather than the bond held by the disregarded entity, and nonetheless could retain the foreign tax credit attributable to the withholding tax imposed on the Freedomian bond. The anomaly lies not with the disregarded entity rule, but rather with a rule that looks to foreign rather than U.S. law in other circumstances.²⁴

III. POLICY AND PREEXISTING AUTHORITIES FAVOR REWRITING THE PROPOSED REGULATIONS.

We respectfully submit that the inevitable consequence of the new requirement set forth in Prop. Reg. § 1.901-2(f)(1)(i) (and illustrated in Examples 2 and 3)—that foreign tax credits may be claimed *neither* by the beneficial owners of securities that must take the associated income into account for U.S. tax purposes, *nor* by their agents or nominees—is inconsistent with the Congressional purpose underlying the foreign tax credit rules. The remainder of this paper demonstrates that the treatment of agency or nominee arrangements in

²³ Prop. Reg. § 1.901-2(f)(3)(ii).

²⁴ The fact pattern suggested in the text (a U.S. taxpayer that holds her Freedomian bond through a disregarded entity) presents an interesting issue in respect of Example 4 as well. Under Prop. Reg. § 1.901-2(f)(3)(ii), the mid-year sale of the disregarded entity will give rise to an allocation of both income and tax credits, which means that the U.S. taxpayer considered in this footnote could obtain a different foreign tax credit result by selling the disregarded entity at mid-year rather than selling the bond owned by the disregarded entity.

the Proposed Regulations is not required by (and, in fact, is inconsistent with) current law, and does not advance a legitimate policy objective.

A. The Result of Example 3 Is Not Required by Prior Authorities.

Part II of this submission has sought to demonstrate that the Proposed Regulations' requirement that the "technical taxpayer" must be the person who is required to take the income in question into account for *foreign* tax purposes (as illustrated in particular by Example 3) would wreak havoc on the capital markets. This Section III.A, in turn, demonstrates that this disruption of settled expectations is *not* mandated by cases that have articulated the technical taxpayer rule or that have addressed the application of the technical taxpayer rule to foreign withholding taxes.

In *Biddle v. Commissioner*, which is widely viewed as the leading technical taxpayer decision, the U.S. Supreme Court considered whether a U.K. tax imposed on U.K. companies upon the payment of a dividend was a shareholder tax or a corporate tax.²⁵ The tax addressed in *Biddle* was imposed on (and collected from) U.K. corporations as a factual matter, but U.K. law treated the shareholders "*as though*" they were the taxpayers.²⁶

Biddle looked to foreign law to help determine the factual resolution of whether the relevant tax was a tax on issuers or a tax on investors, and then rejected further reference to foreign law to characterize that tax—that is, it rejected the relevance of the U.K. law's "as though" reconstruction of the respective liabilities for tax. Relying on its application of the facts to conclude that, under U.S. legal principles, the tax functioned as a corporate-level tax, the

²⁵ 302 U.S. 573 (1938). Under the U.K. integrated tax regime, 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.

²⁶ 302 U.S. at 581 (emphasis supplied).

Court held that the U.S. shareholder in question was not entitled to claim a direct foreign tax credit in respect of those taxes.²⁷ In reaching this conclusion, the Court held that the determination of which person has “paid” a foreign tax must be based upon U.S. tax principles to avoid “a shifting standard . . . adopted by reference to foreign characterizations and classifications.”²⁸

Biddle of course did not deal with an agency or nominee arrangement, and to the extent that this case is thought directly to address such situations, its admonition to rely on U.S. tax principles to avoid the “shifting standard . . . of foreign characterizations and classifications” would argue for precisely the opposite conclusion of that reached by the Proposed Regulations. At most, one can conclude that *Biddle* directly informs the role to be played by foreign law in ascertaining whether a particular tax is an issuer-level tax or an investor-level tax, but does not require the conclusion that foreign law is relevant when ascertaining, in the case of an unquestioned investor-level tax, *which* investor should obtain the foreign tax credit associated with the case in question.

²⁷ 302 U.S. at 581 (“[O]ur 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.”).

²⁸ 302 U.S. at 578 - 79. More specifically, the Court declared:

“Hence the board’s finding, supported as it is by much expert testimony, that “the stockholder receiving the dividend is regarded in the English income tax acts as having paid ‘by deduction or otherwise’ the tax ‘appropriate’ to the dividend” is not conclusive. At most it is but a factor to be considered in deciding whether the stockholder pays the tax within the meaning of our own statute. That must ultimately be determined by ascertaining from an examination of the manner in which the British tax is laid and collected what the stockholder has done in conformity to British law and whether it is the substantial equivalent of payment of the tax as those terms are used in our own statute.” 302 U.S. at 579.

In *U.S. v. Goodyear Tire & Rubber Co.*, the Supreme Court cited *Biddle* for the proposition that “tax provisions should generally be read to incorporate domestic tax concepts absent a clear congressional expression that foreign concepts control.” 493 U.S. 132, 145 (1989). The Court described this rule as a “statutory canon” first adopted in *Biddle*. *Id.*

Cases involving Brazilian and U.K. withholding taxes on interest have consistently held that the U.S. lender should be treated as the person who “paid” the withholding tax 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 contained no remedy against the U.S. lender.²⁹ In *Nissho Iwai American Corp. v. Commissioner*, for example, the Tax Court held that “legal liability” for the Brazilian withholding tax and the obligation to pay the tax are different concepts.³⁰ Citing *Biddle* for the proposition that “United States tax law is the standard for deciding whether a foreign levy is a creditable income tax,”³¹ the court concluded that the Brazilian withholding tax, although actually billed and collected from the *borrower*, is in fact an income tax imposed on the receipt of interest income; therefore, the tax is properly treated as the “legal liability” of the *lender*, who is the owner of the income in respect of which withholding tax was paid.³²

The Tax Court reached a similar conclusion in *Gleason Works v. Commissioner* with respect to a U.K. tax on interest income: the tax was collectible only from the borrower (*i.e.*, the lender had no liability if the borrower failed to pay the tax); nonetheless, because the tax was measured by and imposed on interest income, it was creditable in the hands of the *owner* of such

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

³⁰ 89 T.C. at 773.

³¹ 89 T.C. at 774.

³² *Id.*

income.³³ These cases are consistent with *Biddle*'s admonition that U.S. tax principles should govern the determination of who "paid" the tax.³⁴

As the foregoing cases demonstrate, the United States generally looks to foreign law to determine the relevant facts regarding legal liability for a foreign tax (*e.g.*, the nature and amount thereof, the tax base on which it is imposed, and the person from whom it may be collected), but applies U.S. law to determine the ultimate U.S. tax consequences of this factual determination. As explained by one commentator, "the cases are consistent in allowing 'factual' uses of foreign law and prohibiting 'interpretive' uses of foreign law."³⁵ In other words, foreign law is relevant in determining whether a tax is imposed upon the owner of income or, rather, upon the payor thereof; but once the determination is made that a tax is imposed upon the former, then U.S. tax principles must be applied to determine which person is the owner that has

³³ 58 T.C. at 478.

³⁴ The courts have reached the same conclusion—that the availability of foreign tax credits should be determined by applying U.S. concepts of ownership to the taxable income in question—in cases involving hybrids and reverse hybrids. In *Arundel Corp. v. U.S.*, which involved a hybrid entity, the court concluded that Arundel was entitled to a direct foreign tax credit for Puerto Rican taxes because, under U.S. tax principles, Arundel (as a partner in a partnership) owned the income in question, notwithstanding the Puerto Rican view that the taxpayer actually was a hybrid entity of which Arundel was an owner. 102 F. Supp. 1019 (Ct. Cl. 1952). As the court explained, "[t]he analogy [to *Biddle*] is clear. In *Biddle* the [Supreme] Court resorted to American law to determine, for American tax purposes, whether the taxpayer there had paid the foreign tax, notwithstanding the conflicting foreign concepts. In this case it is the American law which must determine, for American tax purposes, whether the [partner] was the taxpayer of the Puerto Rican tax, notwithstanding Puerto Rican concepts." 102 F. Supp. at 1022. See also *Guardian Industries Corp. v. U.S.*, 65 Fed. Cl. 50 (Fed. Cl. 2005) (holding that because a Luxembourg company was a disregarded entity for U.S. tax purposes, its U.S. owner was eligible for a direct foreign tax credit); *Abbot Laboratories International Co. v. U.S.* (concluding that no foreign tax credits were available to the owner of a reverse hybrid entity, even though such owner was the taxpayer under local law, because under U.S. tax principles the foreign corporation was the true owner of the income subject to foreign tax). 160 F.Supp. 321 (D. Ill. 1958).

³⁵ Phillip R. West, *Foreign Law in U.S. International Taxation: The Search for Standards*, 3 Fla. Tax Rev. 147, 149 (1996).

“paid” the tax in a U.S. sense and, accordingly, should be allowed to claim a foreign tax credit with respect thereto.

In short, neither *Biddle* nor any other case cited above mandates the application of foreign law to determine which investor has “paid” for U.S. federal income tax purposes a tax that unquestionably is an investor-level tax. Moreover, *Biddle* did not address situations involving agency or nominee arrangements: as noted above, *Biddle* considered only whether a particular tax was imposed on a company or its shareholders. In contrast, the issue in situations involving nominee arrangements is whether for U.S. foreign tax credit purposes a tax should be treated as imposed upon a holder of bare legal title to the income associated with that foreign tax, or instead upon the actual owner of that income for all substantive U.S. tax purposes.

B. The Proposed Regulations Are Inconsistent with Foreign Tax Credit Authorities Involving Nominees.

For the reasons described in the preceding section, *Biddle* and the Brazilian withholding tax cases arguably contradict the result reached in Example 3, and certainly do not require it. At the same time, there are other authorities that (unlike *Biddle* and the Brazilian withholding tax cases) *do* address agency arrangements. Those authorities are consistent with current capital markets practice, and thereby support the proposition that the result reached in the final technical taxpayer regulations should reverse the conclusion of Example 3.

Singer Manufacturing Co. v. U.S. involved the U.S. sewing machine company, which had a branch in Italy that it converted to a sales subsidiary.³⁶ On the theory that the U.S. parent was still present in Italy, the Italian government regarded itself as entitled to more tax than it was collecting from the subsidiary subsequent to the conversion. The Italian government negotiated an agreement with the subsidiary whereby the subsidiary would pay tax equal to seven percent of the *parent’s* profits on sales to the subsidiary. The U.S. parent was not a party

³⁶ 87 F. Supp. 769 (Ct. Cl. 1950).

to the agreement, the resulting tax was billed to and collected from the Italian subsidiary, and the U.S. parent did not reimburse its subsidiary for many years for the subsidiary's payment of the resulting tax.

The question raised in *Singer* was whether foreign tax credits were available to the U.S. parent with respect to the Italian taxes paid on its behalf by the subsidiary. The court determined that credits were available to the parent because the Italian tax properly was viewed as a tax on income earned by the *parent*, and because the relationship between the parent and the subsidiary in respect of the Italian tax was, under U.S. principles, that of principal and agent. The *Singer* court therefore concluded that the fact that the tax was billed to and paid by the subsidiary was not relevant.

The Badger Co., Inc. v. Commissioner dealt with an engineering firm that had a complex contract with a foreign subsidiary of Sohio to develop and license a production technology.³⁷ The process was licensed to Japanese entities, which paid royalties to the Sohio subsidiary. The Sohio subsidiary hired Badger in connection with the technology and paid it half of the royalty profits. Badger claimed as foreign tax credits one-half of the Japanese withholding taxes imposed with respect to the royalty payments received by Sohio, on the theory that Badger was a joint venturer with the Sohio subsidiary. The court, however, concluded that Badger was a contract employee and was *not* entitled to foreign tax credits. In analyzing whether Badger was the taxpayer with respect to the Japanese tax, the court stated:

A foreign tax credit may be taken by the taxpayer upon whom the tax to be credited is imposed. *Where a foreign entity acts merely as an agent for an American entity, paying a tax to a foreign country on its principal's behalf, the credit for such taxes is available to the American principal.* In such a case, the taxes have been imposed upon the income of the American principal and not upon the income of the foreign entity, which is considered merely a conduit for the payment of such taxes.³⁸

³⁷ 26 T.C.M. 869 (1967).

³⁸ 26 T.C.M. at 874 (citing *Singer* and *Abbot Laboratories*) (emphasis supplied).

Revenue Ruling 65-218³⁹ considered the tax treatment of ADRs. As noted earlier, that Ruling affirmatively concluded that a holder of an ADR was the owner of the underlying security for all U.S. federal income tax purposes. As a result, the Revenue Ruling concluded (without discussion) that a holder of an ADR is entitled to claim the foreign tax credit on withholding taxes suffered on the underlying securities, without any duty of inquiry into the law of agency in the jurisdiction of the issuer.

Finally, in Revenue Ruling 72-514,⁴⁰ a U.S. parent loaned money to its foreign subsidiary through an undisclosed agent (an international bank) in order to avoid the possible imposition of exchange controls in the foreign subsidiary's jurisdiction. Under the agency agreement between the parent and the bank, the parent advanced funds to the bank, which in turn disbursed loans to the foreign subsidiary. The subsidiary paid interest (subject to local withholding tax) to the bank, which passed such interest (net of withholding) to the parent, unbeknownst to the foreign country. The entire purpose of the arrangement was to hide from the foreign country the true identity of the lender to the foreign subsidiary, and therefore the true owner of the interest income earned on that loan.

The question that Revenue Ruling 72-514 addressed was which entity, in an undisclosed nominee relationship, would be entitled to foreign tax credits for foreign taxes formally imposed on the nominee. Revenue Ruling 72-514 first concluded that the interest income received from the foreign subsidiary in fact was the income of the U.S. parent, relying on an earlier revenue ruling.⁴¹ Revenue Ruling 72-514 then went on to conclude that the principles of *Singer* relating to the establishment of an agency arrangement applied with equal vigor to the

³⁹ 1965-2 C.B. 566.

⁴⁰ 1972-2 C.B. 440.

⁴¹ Rev. Rul. 55-234, 1955-1 C.B. 217 (holding that income realized from a business transacted by a corporation through the agency of one of its officers, acting as a purported sole proprietor, was taxable to the corporation).

facts under consideration, despite the deliberate opacity of the arrangement to the foreign jurisdiction. As a result, the Ruling concluded that the U.S. parent could claim the foreign tax credits attributable to the withholding tax imposed on the subsidiary's interest payments.

These authorities demonstrate that (i) if a person acts merely as an agent or nominee for a U.S. principal, then the foreign income in question should be attributed to the U.S. principal (as the owner of the income under U.S. federal income tax laws), and (ii) the foreign tax imposed upon such income (and the related credits) must be deemed to belong to the principal as well. None of these authorities explicitly suggests that the foreign law characterization of the agency arrangement was relevant to its analysis, and the whole point of Revenue Ruling 72-514 was that the agency arrangement was deliberately constructed to be opaque to the issuer's jurisdiction. In sum, the conclusions reached by the Proposed Regulations do not appear to be supported by the only authorities of which we are aware that have directly considered the availability of the foreign tax credit in agency or nominee situations.

C. The Proposed Regulations Should be Amended with Respect to Agency and Nominee Arrangements to Better Serve Tax Policy Objectives.

1. As Applied to Agency or Nominee Arrangements, the Proposed Regulations Would Further Separate Foreign Income and Tax Credits. Although the technical taxpayer rule has the merits of simplicity, certainty, and administrability, this rule also has enabled certain taxpayers to claim a foreign tax credit in situations where they have not included the related income. The Proposed Regulations would preserve the desirable features of the technical taxpayer rule while modifying the current regulations to prevent the separation of income from foreign tax credits imposed thereon (and therefore from the foreign tax associated therewith), as applied to hybrid entities, reverse hybrid entities, and consolidated groups. While these provisions of the Proposed Regulations raise a number of difficult interpretative issues (not discussed in this submission), we agree with the overall thrust of these proposals, which is to tie tax credits more closely to the income on which the taxes are imposed.

As applied to agency or nominee arrangements, however, the Proposed Regulations would have the perverse consequence of both *separating* income from the associated credits and then effectively *disallowing* those credits. By definition, the holder of bare legal title to a security (whether as a nominee, a custodian, an investment manager, a depository, a lender, or in many cases a trustee) is not the owner of that security or the income derived therefrom for U.S. federal income tax purposes. Consequently, a nominee in every case is precluded from claiming a U.S. foreign tax credit with respect to foreign income,⁴² regardless of what foreign law might say about the matter. At the same time, the Proposed Regulations contemplate that the foreign tax credit is available only to the person that is required to take the income into account for foreign tax purposes.

The consequence of applying these two principles to the fact pattern of a foreign jurisdiction that treats the holder of bare legal title to a security as the person required to take the income from that security into account for its purposes is therefore twofold. First, the actual owner of the security (and the income therefrom) is deprived of the foreign tax credit for taxes that (in all probability) it actually suffered, thereby working a separation of the income from the associated tax credit. Second, the associated tax credit is not in fact made available to the holder of bare legal title because it is *not* the owner of the security, thereby disallowing the foreign tax credit in every case.

This systematic disallowance of foreign tax credits would be directly contrary to the purpose of the foreign tax credit system, which is to relieve double taxation of foreign income. The resulting pattern of double taxation would apply to a wide range of ordinary commercial transactions, would affect virtually every form in which securities are held or traded in the U.S. capital markets, and would reverse decades of uncontroversial practice. We strongly recommend that the regulations be revised to avoid this inappropriate and undesirable outcome.

⁴² See, e.g., IRC § 901(l)(1)(B) and note 12, *supra*.

2. The Proposed Regulations Should Not Be Used to Address Withholding

Tax Arbitrage. In recent years, Congress and the Internal Revenue Service have considered various transactions and arrangements that were designed to give rise to inappropriate foreign tax credit results. To address certain abuses involving withholding taxes, for example, Congress enacted sections 901(k) and 901(l). Prior to the enactment of these provisions, a taxpayer that 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 the taxpayer earned only a small portion of the income (corresponding to its short period of ownership). Congress remedied the mismatch of income and tax credits in this context, *not* by directly revising the technical taxpayer rule, but rather by adopting a minimum “at risk” holding period rule. As described earlier, these provisions can be understood as layering a special *bona fide* beneficial ownership test on top of the technical taxpayer rule for withholding tax credits.

Congress thus has directly addressed the most important classes of withholding tax arbitrage transactions. To be sure, other withholding tax arbitrage transactions may remain, but we believe the section 901 technical taxpayer regulations are no more the place to deal with withholding tax “double dips” (*i.e.*, transactions in which two taxpayers in different jurisdictions obtain a benefit for the same foreign tax credit) than they are to deal with net income tax “double dips.”⁴³ The Internal Revenue Service and the Treasury Department have a wide variety of tools with which to address those “double dips” or other arrangements that they find troubling, but we

⁴³ As noted earlier, Example 3 addresses a sale-repurchase agreement with a five-year term, where the party “reversing in” the security (*i.e.*, the money lender) was a foreign institution. It is possible that the drafters of Example 3 had in mind that, by reaching the conclusion they did, they were foreclosing a “double dip” trade, in which (but for the conclusion reached in the Example) both the U.S. owner of the security and the foreign financing party would claim the foreign tax credit on the underlying bond, and the foreign financing party would share some of the benefits of the tax credit obtained by it with the U.S. owner of the security through a reduction in the explicit interest rate charged the U.S. party under the repo.

respectfully submit that the issues of which sorts of transactions in fact should be viewed as troubling, the criteria used to identify troubling as opposed to acceptable transactions, and the specific consequences of entering into troublesome transactions are all difficult technical and policy questions that go well beyond the scope of the modernization of the technical taxpayer rule. At the same time, for all the reasons demonstrated in this submission, the conclusions reached in Example 3 have the potential to wreak havoc upon a wide array of completely ordinary capital markets transactions.

In these circumstances, we respectfully submit that these technical taxpayer regulations are not the appropriate venue with which to foreclose “double dips” or similar transactions. Instead, the focus of the current regulation project should be on aligning a U.S. taxpayer’s foreign income and its related tax credits to the extent possible. The result reached in Example 4 should remain a modest exception to this principle, determined as much by practical necessity as by logic, and circumscribed in its consequence by the enactment of sections 901(k) and 901(l). By following this approach, the modernized technical taxpayer regulations will advance the purposes of the foreign tax credit system without introducing systematic uncertainty or double taxation in ordinary commercial transactions.

IV. PROPOSALS.

Prop. Reg. § 1.901-2(f)(1)(i) and Examples 2 and 3 represent a substantial departure from prevailing commercial practice and existing law, and would impose an undue burden upon taxpayers, financial services firms, and the Internal Revenue Service. Moreover, the consequences of the proposed regulatory changes are not justified by—and in our view are inconsistent with—important policy objectives. We therefore recommend that the Proposed Regulations be amended by:

- a. Revising Prop. Reg. § 1.901-2(f)(1)(i) to provide that “Income tax (within the meaning of paragraphs (a) through (c) of this section) is considered paid for U.S. income tax purposes by the person on whom foreign law imposes legal liability for such tax. In general, for purposes of this section, the person on

whom foreign law imposes legal liability for such tax shall be determined by first determining the person who is required to take the income into account for foreign income tax purposes (paragraph (f)(4) of this section reserves with respect to certain related party hybrid payments) (the “foreign taxable person”), and then determining under U.S. tax principles who is the owner of the income required to be included by the foreign taxable person at the time the tax is imposed under foreign law. The tax is considered to be paid by the owner of the income, as determined under U.S. tax principles, at the time the tax is imposed under foreign law. This rule applies even if under foreign law another person is obligated to remit the tax”;

- b. Deleting the following sentence from Example 2: “Country X law also recognizes the nominee or agency arrangement and, thus, considers C to be the beneficial owner of the interest income.”; and
- c. Revising the result in Example 3 to provide that “Under paragraph (f)(1)(ii) of this section, B is considered the foreign taxable person with respect to the interest income paid by C. A is considered legally liable for the country X tax because A is the owner of that interest income for U.S. tax purposes, and therefore A is considered for U.S. tax purposes to have paid the tax. The result would be different if the transaction had the effect of transferring ownership of the bond to B for U.S. income tax purposes.”

Under the foregoing approach, the beneficial owner under U.S. tax principles, rather than the agent or nominee, always would be treated as the U.S. taxpayer that “paid” the foreign withholding tax, regardless of whether foreign law respects the agency or nominee arrangement.