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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-124152-06

RIN 1545-BF73

Definition of Taxpayer for Purposes of Section 901 and Related Matters

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing

SUMMARY: These proposed regulations provide guidance relating to the determination of who is considered to pay a foreign tax for purposes of sections 901 and 903. The proposed regulations affect taxpayers that claim direct and indirect foreign tax credits.

DATES: Written or electronic comments must be received by October 3, 2006. Outlines of topics to be discussed at the public hearing scheduled for October 13, 2006, must be received by October 3, 2006.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-124152-06), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be sent electronically via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS and REG-124152-06). The public hearing will be held in the Auditorium, Internal Revenue Service, New Carrollton Building, 5000 Ellin Road, Lanham, MD 20706.

FOR FURTHER INFORMATION CONTACT: Concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Kelly Banks (Kelly.D.Banks@irscounsel.treas.gov); concerning the regulations, Bethany A. Ingwalson, (202) 622-3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 901 of the Internal Revenue Code (Code) permits taxpayers to claim a credit for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States. Section 903 of the Code permits taxpayers to claim a credit for a tax paid in lieu of an income tax.

Section 1.901-2(f)(1) of the current final regulations 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. This legal liability rule applies even if another person, such as a withholding agent, remits the tax. Section 1.901-2(f)(3) 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 tax under foreign law, 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 existing final regulations were published in 1983. Since that time, numerous questions have arisen regarding the application of the legal liability rule to fact patterns not specifically addressed in the regulations or the case law. These include situations in which the members of a foreign consolidated group may not have in the U.S. sense the full equivalent of joint and several liability for the group's consolidated tax liability, and cases in which the person whose income is included in the foreign tax base is not the person who is obligated to remit the tax. Courts have reached inconsistent conclusions on these matters. Compare Nissho Iwai American Corp. v. Commissioner, 89 T.C. 765, 773-74 (1987), Continental Illinois Corp. v. Commissioner, 998 F.2d 513 (7th Cir. 1993), cert. denied, 510 U.S 1041 (1994), Norwest Corp v. Commissioner, 69 F.3d 1404 (8th Cir. 1995), cert. denied, 517 U.S. 1203 (1996), Riggs National Corp. & Subs. v. Commissioner, 107 T.C. 301, rev'd and rem'd on another issue, 163 F.3d 1363 (D.C. Cir. 1999) (all holding that U.S. lenders had legal liability for tax imposed on their interest income from Brazilian borrowers, notwithstanding that under Brazilian law the tax could only be collected from the borrowers) with Guardian Industries Corp. & Subs. v. United States, 65 Fed. Cl. 50 (2005), appeal docketed, No. 2006-5058 (Fed. Cir. December 19, 2005) (concluding that the subsidiary corporations in a Luxembourg consolidated group had no legal liability for tax imposed on their income, because under Luxembourg law the parent corporation was solely liable to pay the tax).

Questions have also arisen regarding the application of the legal liability rule to entities that have different classifications for U.S. and foreign tax law purposes (e.g., hybrid entities and reverse hybrids). This is particularly the case following the promulgation of §§301.7701-1 through -3 (the check the box regulations) in 1997. A hybrid entity is an entity that is treated as a taxable entity (*e.g.*, a corporation) under foreign law and as a partnership or disregarded entity for U.S. tax purposes. For purposes of these regulations, a reverse hybrid is an entity that is a corporation for U.S. tax purposes but is treated as a pass-through entity for foreign tax purposes (*i.e.*, income of the entity is taxed under foreign law at the owner level). Current §1.901-2(f) does not explicitly address how to determine the person that is considered to pay foreign tax imposed on the income of hybrid entities or reverse hybrids.

The IRS and the Treasury Department have determined that the regulations should be updated to clarify the application of the legal liability rule in these situations, and request comments on additional matters that should be addressed in published guidance.

Explanation of Provisions

A. Overview

The IRS and Treasury Department have received substantial comments as to matters that may be addressed under the legal liability rule of §1.901-2(f). These matters include rules relating to the treatment of foreign consolidated groups, reverse hybrids, hybrid entities, hybrid instruments and payments, and other issues. The proposed regulations would provide guidance on foreign consolidated groups, reverse hybrids, and hybrid entities. However, the proposed regulations reserve on issues relating to hybrid instruments and payments, specifically on the question of who is considered to pay tax imposed on income attributable to amounts paid or accrued between related parties under a hybrid instrument or payments that are disregarded for U.S. tax purposes. These and other issues will be addressed in a subsequent guidance project.

The proposed regulations would retain the general principle that tax is considered paid by the person who has legal liability under foreign law for the tax. However, the proposed regulations would further clarify application of the legal liability rule in situations where foreign law imposes tax on the income of one person but requires another person to remit the tax. The proposed regulations make clear that foreign law is considered to impose legal liability for income tax on the person who is required to take such income into account for foreign tax purposes even if another person has the sole obligation to remit the tax (subject to the above-referenced reservation for hybrid instruments and payments).

The proposed regulations would provide detailed guidance regarding how to treat taxes paid on the combined income of two or more persons. First, the proposed regulations would clarify the application of §1.901-2(f) to foreign consolidated-type regimes where the members are not jointly and severally liable in the U.S. sense for the group's tax. The proposed regulations would make clear that the foreign tax must be apportioned among all the members pro rata based on the relative amounts of net income of each member as computed under foreign law. The proposed regulations would provide guidance in determining the relative amounts of net income.

Second, the proposed regulations would revise §1.901-2(f) to provide that a reverse hybrid is considered to have legal liability under foreign law for foreign taxes imposed on an owner of the reverse hybrid in respect of the owner's share of income of the reverse hybrid. The reverse hybrid's foreign tax liability would be determined based on the portion of the owner's taxable income (as computed under foreign law) that is attributable to the owner's share of the income of the reverse hybrid.

Third, the proposed regulations would clarify that a hybrid entity that is treated as a partnership for U.S. income tax purposes is legally liable under foreign law for foreign income tax imposed on the income of the entity, and that the owner of an entity that is disregarded for U.S. income tax purposes is considered to have legal liability for such tax.

These provisions are discussed in more detail below.

B. Legal Liability under Foreign Law

Section 1.901-2(f)(1)(i) of the proposed regulations clarifies that, except for income attributable to related party hybrid payments described in §1.901-2(f)(4), foreign law is considered to impose legal liability for income tax on the person who is required to take such income into account for foreign tax purposes. This paragraph of the proposed regulations further clarifies that such person has legal liability for the tax even if another person is obligated to remit the tax, another person actually remits the tax, or the foreign country (defined in §1.901-2(g) to include political subdivisions and U.S. possessions) can proceed against another person to collect the tax in the event the tax is not paid.

Similarly, §1.902-1(f)(1)(ii) of the proposed regulations clarifies that, in the case of a tax imposed with respect to a base other than income, foreign law is considered to impose legal liability for the tax on the person who is the owner of the tax base for foreign tax purposes. Thus, in the case of a gross basis withholding tax that qualifies as a tax in lieu of an income tax under §1.903-1(a), the proposed regulations provide that the person that is considered under foreign law to earn the income on which the foreign tax is imposed has legal liability for the tax, even if the foreign tax cannot be collected from such person.

The IRS and Treasury Department request comments on whether the regulations should provide a special rule on where legal liability resides in the case of withholding taxes imposed on an amount received by one person on behalf of the beneficial owner of such amount. In certain cases, a foreign country may consider the recipient to earn income (or be the owner of the tax base) while the United States considers the recipient to be a nominee receiving the payment on behalf of the beneficial owner. Comments should focus on how a special rule for such nominee arrangements could be narrowly drawn to prevent opportunities for abuse while maintaining the administrative advantages of the legal liability rule, which generally operates to classify as the taxpayer the person who is in the best position to prove the tax was required to be, and actually was, paid.

C. Taxes Imposed on Combined Income

1. Foreign Consolidated Groups

The IRS and Treasury Department believe that §1.901-2(f)(1) of the current final regulations requires allocation of foreign consolidated tax liability among the members of a foreign consolidated group pro rata based on each member's share of the consolidated taxable income included in the foreign tax base. In addition, the IRS and Treasury Department believe that §1.901-2(f)(3) confirms this rule in situations in which foreign consolidated regimes impose joint and several liability for the group's tax on each member. With respect to a foreign consolidated-type regime where the members do not have the full equivalent of joint and several liability in the U.S. sense, or where the income of the consolidated group members is attributed to the parent corporation in computing the consolidated taxable income, the current regulations do not include a specific illustration of how the consolidated tax should be allocated among the members of the group for foreign tax credit purposes.

Thus, the IRS and Treasury Department believe that §1.901-2(f)(1) of the current final regulations requires as a general rule pro rata allocation of foreign tax among the members of a foreign consolidated group, and that §1.901-2(f)(3) illustrates the application of the general rule in cases where the group members are jointly and severally liable for that consolidated tax. Failure to allocate appropriately the consolidated tax among the members of the group may result in a separation of foreign tax from the income on which the tax is imposed. This type of splitting of foreign tax and income is contrary to the general purpose of the foreign tax credit to relieve double taxation of foreign-source income. Accordingly, §1.901-2(f)(2) of the proposed regulations would explicitly cover all foreign consolidated-type regimes, including those in which the regime imposes joint and several liability in the U.S. sense, those in which the regime treats subsidiaries as branches of the parent corporation (or otherwise attributes income of subsidiaries to the parent corporation), and those in which some of the group members have limited obligations, or even no obligation, to pay the consolidated tax. Several significant commentators recommended that the regulations be clarified in this manner.

The proposed regulations would define combined income to include cases where the foreign country initially recognizes the subsidiaries as separate taxable entities, but pursuant to the applicable consolidated tax regime treats subsidiaries as branches of the parent, requires or treats all income as distributed to the parent, or otherwise attributes all income to the parent. This approach will minimize the need for extensive analysis of the intricacies of the relevant foreign consolidated tax regime, by treating a foreign subsidiary as legally liable for its share of the consolidated tax without regard to the precise mechanics of the foreign consolidated regime. This approach will not only reduce inappropriate foreign tax credit splitting but will also reduce administrative burdens on taxpayers and the IRS.

Section 1.902-1(f)(2) of the proposed regulations retains the general principle that the foreign tax must be apportioned among the persons whose income is included in the combined base pro rata based on the relative amounts of net income of each person as computed under foreign law. As under current law, this rule would apply regardless of which person is obligated to remit the tax, which person actually remits the tax, and which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid. Under §1.902-1(f)(2)(i), person for this purpose includes a disregarded entity.

2. Reverse Hybrid Entities

The proposed regulations would revise §1.901-2(f) to provide that a reverse hybrid is considered to have legal liability under foreign law for foreign taxes imposed on the owners of the reverse hybrid in respect of each owner's share of the reverse hybrid's income. Proposed regulation §1.902-1(f)(2)(iii). This rule is necessary to prevent the inappropriate separation of foreign tax from the related income and to prevent dissimilar treatment of foreign consolidated groups and foreign groups containing reverse hybrids, which are treated identically for U.S. tax purposes. Under the proposed rule, the reverse hybrid's foreign tax liability would be determined based on the portion of the owner's taxable income (as computed under foreign law) that is attributable to the owner's share of the reverse hybrid's income. Thus, for example, if an owner of a reverse hybrid has no other income on which tax is imposed by the foreign country, then the entire amount of foreign tax that is imposed on the owner is treated as attributable to the reverse hybrid for U.S. income tax purposes and, accordingly, is tax for which the reverse hybrid has legal liability. This rule would apply irrespective of whether the owner and the reverse hybrid are located in the same foreign country. If the owner pays tax to more than one foreign country with respect to income of the reverse hybrid, tax paid to each foreign country would be separately apportioned on the basis of the income included in that country's tax base. The treatment of reverse hybrids in the proposed regulations is consistent with the treatment recommended by a significant commentator.

3. <u>Apportionment of Tax on Combined Income</u>

Section 1.901-2(f)(2)(iv) of the proposed regulations includes rules for determining each person's share of the combined income tax base, generally relying on foreign tax reporting of separate taxable income or books maintained for that purpose. The regulations provide that payments between group members that result in a deduction under both U.S. and foreign tax law will be given effect in determining each person's share of the combined income, but, as noted above, explicitly reserve with respect to the effect of hybrid instruments and disregarded payments between related parties (to be dealt with in a separate guidance project). Special rules address the effect of dividends (and deemed dividends) and net losses of group members on the determination of separate taxable income.

Once an amount of foreign tax is determined to be paid by a consolidated group member or reverse hybrid under the combined income rule, applicable provisions of the Code would determine the specific U.S. tax consequences of that treatment. For example, a parent corporation's payment of tax on its subsidiary's share of consolidated taxable income, or the payment of tax by the owner of a reverse hybrid with respect to its share of the income of the reverse hybrid, ordinarily would result in a capital contribution to the subsidiary or reverse hybrid. Further, under sections 902 and 960, domestic corporate owners that own 10 percent or more of a foreign corporation's voting stock are eligible to claim indirect credits. Thus, domestic corporations that are considered to own 10 percent or more of a reverse hybrid's voting stock would be able to claim indirect credits for the taxes attributable to the earnings of the reverse hybrid that are distributed as dividends or otherwise included in the owner's income for U.S. tax purposes.

D. Hybrid Entities

Section 1.901-2(f)(3) of the proposed regulations would also clarify the treatment of hybrid entities. In the case of an entity that is a partnership for U.S. income tax purposes but taxable under foreign law as an entity, foreign law is considered to impose legal liability for the tax on the entity. This is the case even if the owners of the entity also have a secondary obligation to pay the tax. Sections 702, 704, and 901(b)(5) and the Treasury regulations thereunder apply for purposes of allocating the foreign tax among the owners of a hybrid entity that is a partnership for U.S. tax purposes. In the case of tax imposed on an entity that is disregarded as separate from its owner for U.S. income tax purposes, foreign law is considered to impose legal liability for the tax on the owner.

E. Effective Date

The regulations are proposed to be effective for foreign taxes paid or accrued during taxable years beginning on or after January 1, 2007. Comments are requested as to how to determine which person paid a foreign tax in cases where a foreign taxable year ends, and foreign tax accrues, within a post-effective date U.S. taxable year of a reverse hybrid and a pre-effective date U.S. taxable year of its owner.

F. Request for Additional Comments

As indicated above, in developing these proposed regulations, the IRS and Treasury Department considered comments on the proper scope and content of the regulations. Commentators generally agreed that amendments to clarify that foreign tax is properly apportioned among the members of a foreign consolidated group were appropriate. Commentators also agreed that the regulations should clarify that tax imposed on a disregarded entity is considered paid by its owner, and that tax imposed on a hybrid partnership should be allocated under the rules of sections 702, 704, and 901(b)(5). Some comments strongly stated that the IRS and Treasury Department have authority to extend the scope of the regulations to require the attribution of foreign tax to reverse hybrids. One comment, however, suggested that the IRS and Treasury Department may lack such authority. The IRS and Treasury Department considered these comments and concluded that the proposed regulations are well within applicable regulatory authority and fully consistent with the case law, including Biddle v. Commissioner, 302 U.S. 573 (1938).

Comments also suggested that the IRS and Treasury Department should extend the scope of the regulations to ensure that hybrid instruments and hybrid entities could not be used effectively to separate foreign tax from the related foreign income. As indicated above, however, the IRS and Treasury Department have decided not to exercise this authority in these regulations. The proposed regulations reserve on the effect given to hybrid payments and disregarded payments in determining the person whose income is subject to foreign tax. The IRS and Treasury Department are continuing to study certain transactions employing hybrid instruments and other transactions designed to generate inappropriate foreign tax credit results. These include the use of hybrid instruments that accrue income for foreign tax purposes, but not U.S. tax purposes, to accelerate the payment of creditable foreign taxes before the related income is subject to U.S. tax. These also include the use of disregarded payments to shift foreign tax liabilities away from the person that is considered to earn the associated taxable income for U.S. tax purposes. It is contemplated that some or all of these issues will be addressed in a separate guidance project, and that any such regulations may also be effective for taxable years beginning on or after January 1, 2007.

The IRS and Treasury Department request additional comments regarding the appropriate application of the legal liability rule to hybrid instruments and payments that are disregarded for U.S. tax purposes. They also request comments on other issues that might be incorporated into final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6), does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 13, 2006, beginning at 10:00 a.m. in the Auditorium, Internal Revenue Service, New Carrollton Building, 5000 Ellin Road, Lanham, MD 20706. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit electronic or written comments and an outline of the topics to be discussed and time to be devoted to each topic (a signed original and eight (8) copies) by October 3, 2006. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Bethany A. Ingwalson, Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part I

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1 -- INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.706-1, paragraph (c)(6) is added to read as follows:

§1.706-1 Taxable years of partner and partnership.

* * * * *

(c) * * *

(6) Foreign taxes. For rules relating to the treatment of foreign taxes paid or accrued by a partnership, see §1.901-2(f)(3)(i) and (ii).

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Par. 3. In §1.901-2, paragraphs (f) and (h) are revised to read as follows:

§1.901-2 Income, war profits, or excess profits tax paid or accrued.

* * * * *

(f) Taxpayer--(1) In general--(i) Income taxes. 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, 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 (paragraph (f)(4) of this section reserves with respect to certain related party hybrid payments). This rule applies even if under foreign law another person is obligated to remit the tax, another person (e.g., a withholding agent) actually remits the tax, or foreign law permits the foreign country to proceed against another person to collect the tax in the event the tax is not paid. However, see section 905(b) and the regulations thereunder for rules relating to proof of payment. Except as provided in paragraph (f)(2)(i) of this section, for purposes of this section the term <u>person</u> has the meaning set forth in section 7701(a)(1), and so includes an entity treated as a corporation, trust, estate or partnership for U.S. tax purposes, but not a disregarded entity described in §301.7701-2(c)(2)(i) of this chapter. The person on whom foreign law imposes legal liability is referred to as the "taxpayer" for purposes of this section, §1.901-2A, and §1.903-1.

(ii) <u>Taxes in lieu of income taxes</u>. The principles of paragraph (f)(1)(i) and paragraphs (f)(2) through (f)(5) of this section shall apply to determine the person who is considered to have legal liability for, and thus to have paid, a tax in lieu of an income tax (within the meaning of §1.903-1(a)). Accordingly, foreign law is considered to impose legal liability for any such tax on the person who is the owner of the base on which the tax is imposed for foreign tax purposes.

(2) Taxes on combined income of two or more persons--(i) In general. If foreign tax is imposed on the combined income of two or more persons (for example, a husband and wife or a corporation and one or more of its subsidiaries), foreign law is considered to impose legal liability on each such person for the amount of the tax that is attributable to such person's portion of the base of the tax. Therefore, if foreign tax is imposed on the combined income of two or more persons, such tax shall be allocated among, and considered paid by, such persons on a pro rata basis. For this purpose, the term pro rata means in proportion to each person's portion of the combined income, as determined under paragraph (f)(2)(iv) of this section and, generally, under foreign law. The rules of this paragraph (f)(2) apply regardless of which person is obligated to remit the tax, which person actually remits the tax, or which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid. For purposes of this paragraph (f)(2), the term person shall include a disregarded entity described in §301.7701-2(c)(2)(i) of this chapter. In determining the amount of tax paid by an owner of a hybrid partnership or disregarded entity (as defined in paragraph (f)(3) of this section), this paragraph (f)(2) shall first apply to determine the amount of tax paid by the hybrid partnership or disregarded entity, and then paragraph (f)(3) of this section shall apply to allocate the amount of such tax to the owner.

(ii) Combined income. For purposes of this paragraph (f)(2), foreign tax is imposed on the combined income of two or more persons if such persons compute their taxable income on a combined basis under foreign law. Foreign tax is considered to be imposed on the combined income of two or more persons even if the combined income is computed under foreign law by attributing to one such person (e.g., the foreign parent of a foreign consolidated group) the income of other such persons. However, foreign tax is not considered to be imposed on the combined income of two or more persons solely because foreign law --

(A) Permits one person to surrender a net loss to another person pursuant to a group relief or similar regime;

(B) Requires a shareholder of a corporation to include in income amounts attributable to taxes imposed on the corporation with respect to distributed earnings, pursuant to an integrated tax system that allows the shareholder a credit for such taxes; or

(C) Requires a shareholder to include, pursuant to an anti-deferral regime (similar to subpart F of the Internal Revenue Code (sections 951 through 965)), income attributable to the shareholder's interest in the corporation.

(iii) Reverse hybrid entities. For purposes of this paragraph (f)(2), if an entity is a corporation for U.S. income tax purposes and a person is required to take all or a part of the income of one or more such entities into account under foreign law because the entity is treated as a branch or a pass-through entity under foreign law (a reverse hybrid), tax imposed on the person's share of income from each reverse hybrid and tax imposed by the foreign country on other income of the person, if any, is considered to be imposed on the combined income of the person and each reverse hybrid. Therefore, under paragraph (f)(2)(i) of this section, foreign tax imposed on the combined income of the person and each reverse hybrid shall be allocated between the person and the reverse hybrid on a pro rata basis. For this purpose, the term pro rata means in proportion to the portion of the combined income included in the foreign tax base that is attributable to the person's share of income from each reverse hybrid and the portion of the combined income that is attributable to the other income of the person (including income received from a reverse hybrid other than in the owner's capacity as an owner). If the person has a share of income from the reverse hybrid but no other income on which tax is imposed by the foreign country, the entire amount of foreign tax is allocated to and considered paid by the reverse hybrid.

(iv) Portion of combined income–(A) In general. Except with respect to income attributable to related party hybrid payments or accrued amounts described in paragraph (f)(4) of this section, each person's portion of the combined income shall be determined by reference to any return, schedule or other document that must be filed or maintained with respect to a person showing such person's income for foreign tax purposes, as properly amended or adjusted for foreign tax purposes. If no such return, schedule or document must be filed or maintained with respect to a person for foreign tax purposes, then, for purposes of this paragraph (f)(2), such person's income shall be determined from the books of account regularly maintained by or on behalf of the person for purposes of computing its taxable income under foreign law.

(B) Effect of certain payments. Each person's portion of the combined income shall be determined by giving effect to payments and accrued amounts of interest, rents, royalties, and other amounts to the extent such payments or accrued amounts are taken into account in computing the separate taxable income of such person both under foreign law and under U.S. tax principles. With respect to certain related party hybrid payments, see the reservation in paragraph (f)(4) of this section. Thus, for example, interest paid by a reverse hybrid to one of its owners with respect to an instrument that is treated as debt for both U.S. and foreign tax purposes would be considered income of the owner and would reduce the taxable income of the reverse hybrid. However, each person's portion of the combined income shall be determined without taking into account any payments from other persons whose income is included in the combined base that are treated as dividends under foreign law, and without taking into account deemed dividends or any similar attribution of income made for purposes of computing the combined income under foreign law. This rule applies regardless of whether any such dividend, deemed dividend or attribution of income results in a deduction or inclusion under foreign law.

(C) Net losses. If tax is considered to be imposed on the combined income of three or more persons and one or more of such persons has a net loss for the taxable year for foreign tax purposes, the following rules apply. If foreign law provides mandatory rules for allocating the net loss among the other persons, then the rules that apply for foreign tax purposes shall apply for purposes of paragraph (f)(2)(iv) of this section. If foreign law does not provide mandatory rules for allocating the net loss, the net loss shall be allocated among all other such persons pro rata based on the amount of each person's income, as determined under paragraphs (f)(2)(iv)(A) and (B) of this section. For purposes of this paragraph (f)(2)(iv)(C), foreign law shall not be considered to provide mandatory rules for allocating a loss solely because such loss is attributed from one person to a second person for purposes of computing combined income, as described in paragraph (f)(2)(ii) of this section.

(v) Collateral consequences. U.S. tax principles shall apply to determine the tax consequences if one person remits a tax that is the legal liability of, and thus is considered paid by, another person. For example, a payment of tax for which a corporation has legal liability by a shareholder of that corporation (including an owner of a reverse hybrid) will ordinarily result in a deemed capital contribution and deemed payment of tax by the corporation. If the corporation reimburses the shareholder for the tax payment, such reimbursement would ordinarily be treated as a distribution for U.S. tax purposes.

(3) Taxes on income of hybrid partnerships and disregarded entities–(i) Hybrid partnerships. If foreign law imposes tax at the entity level on the income of an entity that is treated as a partnership for U.S. income tax purposes (a hybrid partnership), the hybrid partnership is considered to be legally liable for such tax under foreign law. Therefore, the hybrid partnership is considered to pay the tax for U.S. income tax purposes. See §1.704-1(b)(4)(viii) for rules relating to the allocation of such tax among the partners of the partnership. If the hybrid partnership's U.S. taxable year closes for all partners due to a termination of the partnership under section 708 and the regulations thereunder (other than in the case of a termination under section 708(b)(1)(A)) and the foreign taxable

year of the partnership does not close, then foreign tax paid or accrued by the partnership with respect to the foreign taxable year that ends with or within the new partnership's first U.S. taxable year shall be allocated between the terminating partnership and the new partnership. The allocation shall be made under the principles of §1.1502-76(b) based on the respective portions of the taxable income of the partnership (as determined under foreign law) for the foreign taxable year that are attributable to the period ending on and the period ending after the last day of the terminating partnership's U.S. taxable year. The principles of the preceding sentence shall also apply if the hybrid partnership's U.S. taxable year closes with respect to one or more, but less than all, partners or, except as otherwise provided in section 706(d)(2) or (d)(3) (relating to certain cash basis items of the partnership), there is a change in any partner's interest in the partnership during the partnership's U.S. taxable year. If, as a result of a change in ownership during a hybrid partnership's foreign taxable year, the hybrid partnership becomes a disregarded entity and the entity's foreign taxable year does not close, foreign tax paid or accrued by the disregarded entity with respect to the foreign taxable year shall be allocated between the hybrid partnership and the owner of the disregarded entity under the principles of this paragraph (f)(3)(i).

(ii) Disregarded entities. If foreign tax is imposed at the entity level on the income of an entity described in §301.7701-2(c)(2)(i) of this chapter (a disregarded entity), foreign law is considered to impose legal liability for the tax on the person who is treated as owning the assets of the disregarded entity for

U.S. income tax purposes. Such person shall be considered to pay the tax for U.S. income tax purposes. If there is a change in the ownership of such disregarded entity during the entity's foreign taxable year and such change does not result in a closing of the disregarded entity's foreign taxable year, foreign tax paid or accrued with respect to such foreign taxable year shall be allocated between the old owner and the new owner. The allocation shall be made under the principles of §1.1502-76(b) based on the respective portions of the taxable income of the disregarded entity (as determined under foreign law) for the foreign taxable year that are attributable to the period ending on the date of the ownership change and the period ending after such date. If, as a result of a change in ownership, the disregarded entity becomes a hybrid partnership and the entity's foreign taxable year does not close, foreign tax paid or accrued by the hybrid partnership with respect to the foreign taxable year shall be allocated between the old owner and the hybrid partnership under the principles of this paragraph (f)(3)(ii). If the person who owns a disregarded entity is a partnership for U.S. income tax purposes, see §1.704-1(b)(4)(viii) for rules relating to the allocation of such tax among the partners of the partnership.

(4) Tax on income attributable to related party payments or accrued amounts that are deductible for foreign (or U.S.) tax law purposes and that are nondeductible for U.S. (or foreign) tax law purposes or that are disregarded for U.S. tax law purposes. [Reserved].

(5) Party undertaking tax obligation as part of transaction. Tax is considered paid by the taxpayer even if another 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. The rules of the foregoing sentence apply notwithstanding anything to the contrary in paragraph (e)(3) of this section. See §1.901-2A for additional rules regarding dual capacity taxpayers.

(6) Examples. The following examples illustrate the rules of paragraphs (f)(1) through (f)(5) of this section.

Example 1. (i) Facts. Under a loan agreement between A, a resident of country X, and B, a United States person, A agrees to pay B a certain amount of interest net of any tax that country X may impose on B with respect to its interest income. Country X imposes a 10 percent tax on the gross amount of interest income received by nonresidents of country X from sources in country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of § 1.903-1(a). Under the law of country X this tax is imposed on the interest income of the nonresident recipient, and any resident of country X that pays such interest to a nonresident is required to withhold and pay over to country X 10 percent of the amount of such interest. Under the law of country X, the country X taxing authority may proceed against A, but not B, if A fails to withhold and pay over the tax to country X.

(ii) Result. Under paragraph (f)(1)(ii) of this section, B is considered legally liable for the country X tax because such tax is imposed on B’s interest income. Therefore, for U.S. income tax purposes, B is considered to pay the country X tax, and B’s interest income includes the amount of country X tax that is imposed with respect to such interest income and paid on B’s behalf by A. No portion of such tax is considered paid by A.

Example 2. (i) Facts. The facts are the same as in Example 1, except that in collecting and receiving the interest B is acting as a nominee for, or agent of, C, who is a United States person. Accordingly, C, not B, is the beneficial owner of the interest for U.S. income tax purposes. Country X law also recognizes the nominee or agency arrangement and, thus, considers C to be the beneficial owner of the interest income.

(ii) Result. Under paragraph (f)(1)(ii) of this section, legal liability for the tax is considered to be imposed on C, not B (C's nominee or agent). Thus, C is the taxpayer with respect to the country X tax imposed on C's interest income from C's loan to A. Accordingly, C's interest income for U.S. income tax purposes includes the amount of country X tax that is imposed on C with respect to such interest income and that is paid on C's behalf by A pursuant to the loan agreement. Under paragraph (f)(1)(ii) of this section, such tax is considered for U.S. income tax purposes to be paid by C. No such tax is considered paid by B.

Example 3. (i) Facts. A, a U.S. person, owns a bond issued by C, a resident of country X. On January 1, 2008, A and B enter into a transaction in which A, in form, sells the bond to B, also a U.S. person. As part of the transaction, A and B agree that A will repurchase the bond from B on December 31, 2013 for the same amount. In addition, B agrees to make payments to A equal to the amount of interest B receives from C. As a result of the arrangement, legal title to the bond is transferred to B. The transfer of legal title has the effect of transferring ownership of the bond to B for country X tax purposes. A remains the owner of the bond for U.S. income tax purposes. Country X imposes a 10 percent tax on the gross amount of interest income received by nonresidents of country X from sources in country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of § 1.903-1(a). Under the law of country X this tax is imposed on the interest income of the nonresident recipient, and any resident of country X that pays such interest to a nonresident is required to withhold and pay over to country X 10 percent of the amount of such interest. On December 31, 2008, C pays B interest on the bond and withholds 10 percent of country X tax.

(ii) Result. Under paragraph (f)(1)(ii) of this section, B is considered legally liable for the country X tax because B is the owner of the interest income for country X tax purposes, even though A and not B recognizes the interest income for U.S. tax purposes. The result would be the same if the transaction had the effect of transferring ownership of the bond to B for U.S. income tax purposes.

Example 4. (i) Facts. On January 1, 2007, A, a United States person, purchases a bond issued by X, a foreign person resident in county Y. A accrues interest income on the bond for U.S. tax purposes from January 1, 2007, until A sells the bond to B, another United States person, on July 1, 2007. On December 31, 2007, X pays interest on the bond that accrued for the entire year to B. Country Y imposes a 10 percent tax on the gross amount of interest income received by nonresidents of country Y from sources in country Y, and it is established that this tax is a tax in lieu of an income tax within the meaning of § 1.903-1(a). Under the law of country Y this tax is imposed on the interest income of the nonresident recipient, and any resident of country Y that pays such interest to a nonresident is required to withhold and pay over to country X 10 percent of the amount of such interest. Pursuant to the law of country Y, X withholds tax from the interest paid to B.

(ii) Result. Under paragraph (f)(1)(ii) of this section, legal liability for the tax is considered to be imposed on B. Thus, B is the taxpayer with respect to the entire amount of the country Y tax even though, for U.S. income tax purposes, B only recognizes interest that accrues on the bond on and after July 1, 2007. No portion of the country Y tax is considered to be paid by A even though, for U.S. income tax purposes, A recognizes interest on the bond that accrues prior to July 1, 2007.

Example 5. (i) Facts. A, a United States person and resident of country X, is an employee of B, a corporation organized in country X. Under the laws of country X, B is required to withhold from A's wages and pay over to country X foreign social security tax of a type described in paragraph (a)(2)(ii)(C) of this section, and it is established that this tax is an income tax described in paragraph (a)(1) of this section.

(ii) Result. Under paragraph (f)(1)(i) of this section, A is considered legally liable for the country X tax because such tax is imposed on A's wages. Therefore, for U.S. income tax purposes, A is considered to pay the country X tax.

Example 6. (i) Facts. A, a United States person, owns 100 percent of B, an entity organized in country X. B is a corporation for country X tax purposes, and a disregarded entity for U.S. income tax purposes. B owns 100 percent of corporation C and corporation D, both of which are also organized in country X. B, C and D use the "u" as their functional currency and file on a combined basis for country X income tax purposes. Country X imposes an income tax described in paragraph (a)(1) of this section at the rate of 30 percent on the taxable income of corporations organized in country X. Under the country X combined reporting regime, income (or loss) of C and D is attributed to, and treated as income (or loss) of, B. B has the sole obligation to pay country X income tax imposed with respect to income of B and income of C and D that is attributed to, and treated as income of, B. Under the law of country X, country X may proceed against B, but not C or D, if B fails to pay over to country X all or any portion of the country X income tax imposed with respect to such income. In year 1, B has taxable income of 100u, C has taxable income of 200u, and D has a net loss of (60u). Under the law of country X, B is considered to have 240u of taxable income with respect to which 72u of country X income tax is imposed. Country X does not provide mandatory rules for allocating D's loss.

(ii) Result. Under paragraph (f)(2)(ii) of this section, the 72u of country X tax is considered to be imposed on the combined income of B, C, and D. Because country X law does not provide mandatory rules for allocating D's loss between B and C, under paragraph (f)(2)(iv)(C) of this section D's (60u) loss is allocated pro rata: 20u to B ((100u/300u) x 60u) and 40u to C ((200u/300u) x 60u). Under paragraph (f)(2)(i) of this section, the 72u of country X tax must be allocated pro rata among B, C, and D. Because D has no income for country X tax purposes, no country X tax is allocated to D. Accordingly, 24u (72u x

(80u/240u)) of the country X tax is allocated to B, and 48u (72u x (160u/240u)) of such tax is allocated to C. Under paragraph (f)(3)(ii) of this section, A is considered to have legal liability for the 24u of country X tax allocated to B under paragraph (f)(2) of this section.

Example 7. (i) Facts. A, a domestic corporation, owns 95 percent of the voting power and value of C, an entity organized in country Z that uses the "u" as its functional currency. B, a domestic corporation, owns the remaining 5 percent of the voting power and value of C. Pursuant to an election made under §301.7701-3(a), C is treated as a corporation for U.S. income tax purposes, but as a partnership for country Z income tax purposes. Accordingly, under country Z law, A and B are required to take into account their respective shares of the taxable income of C. Country Z imposes an income tax described in paragraph (a)(1) of this section at the rate of 30 percent on such taxable income. For 2007, C has 500u of taxable income for country Z tax purposes. A's and B's shares of such income are 475u and 25u, respectively. In addition, A has 125u of taxable income attributable to a permanent establishment in country Z. Income of nonresidents that is attributable to a permanent establishment in country Z is also subject to the country Z income tax at a rate of 30 percent. Accordingly, country Z imposes 180u of tax on A's total taxable income of 600u (475u of income from C and 125u of income from the permanent establishment). Country Z imposes 7.5u of tax on B's 25u of taxable income from C.

(ii) Result. Under paragraph (f)(2)(iii) of this section, the 180u of tax imposed on the taxable income of A is considered to be imposed on the combined income of A and C. Under paragraph (f)(2)(i) of this section, such tax must be allocated between A and C on a pro rata basis. Accordingly, C is considered to be legally liable for the 142.5u (180u x (475u/600u)) of country Z tax imposed on A's 475u share of C's income, and A is considered to be legally liable for the 37.5u (180u x (125u/600u)) of the country Z tax imposed on A's 125u of income from its permanent establishment. Under paragraph (f)(2)(iii) of this section, the 7.5u of tax imposed on the taxable income of B is considered to be imposed on the combined income of B and C. Since B has no other income on which income tax is imposed by country Z, under paragraph (f)(2)(iii) of this section the entire amount of such tax is allocated to and considered paid by C. C's post-1986 foreign income taxes include the U.S. dollar equivalent of 150u of country Z income tax C is considered to pay for U.S. income tax purposes. A, but not B, is eligible to compute deemed-paid taxes under section 902(a) in connection with dividends received from C. Under paragraph (f)(2)(v) of this section, the payment by A or B of tax for which C is considered legally liable is treated as a capital contribution by A or B to C.

Example 8. (i) Facts. A, B, and C are U.S. persons that each use the calendar year as their taxable year. A and B each own 50 percent of the capital and profits of D, an entity organized in country M. D is a partnership for U.S.

income tax purposes, but is a corporation for country M tax purposes. D uses the "u" as its functional currency and the calendar year as its taxable year for both U.S. tax purposes and country M tax purposes. Country M imposes an income tax described in paragraph (a)(1) of this section at a rate of 30 percent at the entity level on the taxable income of D. On September 30, 2008, A sells its 50 percent interest in D to C. A's sale of its partnership interest results in a termination of the partnership under section 708(b) for U.S. tax purposes. As a result of the termination, "old" D's taxable year closes on September 30, 2008 for U.S. tax purposes. New D also has a short U.S. taxable year, beginning on October 1, 2008, and ending on December 31, 2008. The sale of A's interest does not close D's taxable year for country M tax purposes. D has 400u of taxable income for its 2008 foreign taxable year with respect to which country M imposes 120u equal to $120 of income tax.

(ii) Result. Under paragraph (f)(3)(i) of this section, hybrid partnership D is legally liable for the $120 of country M income tax imposed on its net income. Because D's taxable year closes on September 30, 2008, for U.S. tax purposes, but does not close for country M tax purposes, under paragraph (f)(3)(i) of this section the $120 of country M tax must be allocated under the principles of §1.1502-76(b) between the short U.S. taxable years of terminating D and new D. See §1.704-1(b)(4)(viii) for rules relating to the allocation of terminating D's country M taxes between A and B and the allocation of new D's country M taxes between B and C.

Example 9. (i) Facts. A, a United States person engaged in construction activities in country X, is subject to the country X income tax. Country X has contracted with A for A to construct a naval base. A is a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) and, in accordance with paragraphs (a)(1) and (c)(1) of §1.901-2A, A has established that the country X income tax as applied to dual capacity persons and the country X income tax as applied to persons other than dual capacity persons together constitute a single levy. A has also established that that levy is an income tax within the meaning of paragraph (a)(1) of this section. Pursuant to the terms of the contract, country X has agreed to assume any country X income tax liability that A may incur with respect to A's income from the contract.

(ii) Result. For U.S. income tax purposes, A's income from the contract includes the amount of tax that is imposed by country X on A with respect to its income from the contract and that is assumed by country X; and the amount of the tax liability assumed by country X is considered to be paid by A. By reason of paragraph (f)(5) of this section, country X is not considered to provide a subsidy, within the meaning of section 901(i) and paragraph (e)(3) of this section, to A.

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(h) Effective Date. Paragraphs (a) through (e) and paragraph (g) of this section, §1.901-2A and §1.903-1 apply to taxable years beginning after

November 14, 1983. Paragraph (f) of this section is effective for foreign taxes paid or accrued during taxable years of the taxpayer beginning on or after January 1, 2007.

Mark E. Matthews

Deputy Commissioner for Services and Enforcement.