Anti-Deferral and Anti-Tax Avoidance

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Proposed Regulations "Clarifying" the Technical Taxpayer Rule Don't Pass the Giggle Test

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On August 4, 2006, the Treasury and the IRS issued proposed regulations (the "Proposed Regulations") under Code Sec. 901 of the Internal Revenue Code of 1986, as amended (the "Code"). The Proposed Regulations purport to retain the longstanding technical taxpayer rule, but this clearly is not the case. Under the Proposed Regulations, persons who demonstrably have no liability under foreign law are deemed to have such liability in order to maintain the fiction that the technical taxpayer rule remains intact. This fiction is unpersuasive, however, and the Proposed Regulations simply do not pass the giggle test.

Origin of the Technical Taxpayer Rule: *M.D. Biddle*

In *M.D. Biddle*,[1] the Supreme Court considered whether certain British taxes imposed in connection with a British corporation's distribution of dividends to its shareholders should be treated as "paid" by those shareholders and, consequently, creditable under the foreign tax credit provisions of the Revenue Act of 1928. The status of the British tax was somewhat uncertain due to the integration of the corporate and personal income taxes under the British tax laws. On the one hand, the tax could be collected only from the corporation. On the other hand, an individual shareholder liable for British surtax on account of having income in excess of a specified threshold was treated as having received an additional dividend equal to a

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portion of the tax deducted by the corporation and was permitted to credit that amount against his personal liability for the surtax.

Conceding that the latter features of the British tax system "treat the stockholder as though he were the taxpayer" for certain limited purposes, the Supreme Court nevertheless held that the shareholders, who had no legal duty to pay the tax, could not be treated as having paid the tax collected from the corporation. Thus, the Supreme Court generally has been understood to have adopted a "technical taxpayer rule" pursuant to which a person who has no liability for a tax obligation under foreign law cannot be considered to have "paid" such tax and, consequently, cannot claim a foreign tax credit for the amount paid.

Following *Biddle*, it has long been understood, and the Treasury Regulations currently provide, that the foreign tax is considered to be paid by, and thus the foreign tax credit may only be granted to, the person liable for the tax under foreign law. Thus, for example, a foreign dividend withholding tax may be creditable to the shareholder, provided that the shareholder is liable for such tax under foreign law, notwithstanding that the amount due is collected from the corporation instead of the shareholder.

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Inadequacies of the Technical Taxpayer Rule

The technical taxpayer rule arguably arrives at improper results where the person liable for the foreign tax is not the same person who actually earned the income on which such tax is imposed. Thus, for example, if a U.S. parent corporation were solely liable for the foreign tax liabilities of its Luxembourg subsidiaries, a legitimate policy argument can be made that such foreign taxes should not be creditable until the Luxembourg subsidiaries pay dividends to the U.S. parent. Indeed, deferring the foreign tax credit until such time as the corresponding income is subject to U.S. tax would be fully consistent with the foreign tax credit's underlying policy of avoiding double taxation. Pursuant to the technical taxpayer rule, however, it appears that the U.S. parent must be regarded as having paid the foreign tax for which it, and it alone, is liable under Luxembourg law. Absent some further limitation,[2] the foreign tax so paid should be creditable.

Indeed, the taxpayer won a victory on similar facts in *Guardian Industries Corp. & Subs.*[3] In *Guardian Industries*, the parent of a combined group of Luxembourg corporations was a hybrid disregarded entity owned by a member of a U.S. consolidated group. The taxpayer argued that (1) under Luxembourg law, the parent of a combined group is solely liable for the tax imposed on the combined income of the group and, consequently, is the sole payor of the group's full tax liability under the technical taxpayer rule; and (2) since the Luxembourg parent is a disregarded entity for U.S. tax purposes, the Luxembourg taxes paid by it should be treated as paid by the disregarded entity's U.S. owner.

The Court of Claims agreed with the taxpayer. The IRS argued that the subsidiaries were each liable for a portion of the group's tax liability, but this argument was rejected. At that point, nothing prevented a taxpayer victory pursuant to a straightforward application of the technical taxpayer rule.[4] The regulations provide for an allocation of the foreign taxes paid in certain cases involving related persons with joint and several liability, but these rules had no application where the parent of the group was solely liable.[5]

As discussed below, the Proposed Regulations would attempt to prevent any such "splitting" of foreign taxes from the foreign tax base by effectively eliminating the technical taxpayer rule.

The Proposed Regulations

The Proposed Regulations purport to retain the technical taxpayer rule: "Income tax … is considered paid for U.S. income tax purposes by the person on whom foreign law imposes legal liability for such tax."[6] The Proposed Regulations further provide that "[i]n 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."[7] The preamble to the Proposed

Regulations (the "Preamble") describes this "Deemed Liability Rule" as a "clarification" of the technical taxpayer rule.

The Proposed Regulations also provide a "Combined Income Rule" pursuant to which a foreign income tax imposed on the combined income of two or more persons is allocated among those persons in proportion to their respective incomes, as determined for foreign tax purposes:

> If foreign tax is imposed on the combined income of two or more persons … 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.[8]

The Proposed Regulations further provide that foreign tax is considered to be imposed on the combined income of two or more persons (and, therefore, the Combined Income Rule applies) if such persons compute their taxable income on a combined basis under foreign law. This requirement is satisfied "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."[9] Such requirement is not satisfied, however, and thus the Combined Income Rule does not apply, solely because foreign law (1) permits one person to surrender a net loss to another person; (2) requires a shareholder to include in income amounts attributable to taxes imposed on distributed corporate earnings under an integrated tax system that allows the shareholder a credit for such taxes; or (3) requires a shareholder to include amounts in income under an anti-deferral regime similar to subpart F.[10]

For purposes of the Combined Income Rule, the Proposed Regulations provide a special rule applicable to income earned through a reverse hybrid entity (RHE). Pursuant to this "Deemed Combination Rule," the tax imposed on income earned through an RHE is *considered* to be imposed on the combined income of the RHE and the person who owns an interest in the RHE.[11] The Deemed Liability and Combined Income Rules then deem the RHE to be liable for such tax under foreign law, even though such liability may in fact be imposed solely on the owner or owners of the RHE.

The Proposed Regulations provide an "As-Prepared Rule" pursuant to which each person's share of the foreign tax imposed on the combined income of two or more persons by reference to any "return, schedule or other document that must be filed or maintained for foreign tax purposes, as properly amended or adjusted for foreign tax purposes." Under the As-Prepared Rule, it appears that any such documents prepared by the taxpayer will be dispositive, and that the IRS may not look behind those documents to argue that the taxpayer improperly applied the foreign tax laws.[12]

The Proposed Regulations further provide that "[e]ach 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."[13] Although not expressly stated, the apparent import of this provision is that related-party payments and accrued amounts that are *not* taken into account under U.S. (as well as foreign) tax principles will *not* be given effect. This "Related-Party Disallowance Rule" is a significant limitation on the As-Prepared Rule.[14]

Comments on the Proposed Regulations

As noted above, the Proposed Regulations purport to retain the technical taxpayer rule: "Income tax … is considered paid for U.S. income tax purposes by the person on whom foreign law imposes legal liability for such tax."[15]

The Preamble echoes the party line admirably: "The proposed regulations would retain the general principal that tax is considered paid by the person who has legal liability under foreign law for the tax."

Unfortunately, you can't always believe what you read. As noted above, the Proposed Regulations also impose a Deemed Liability Rule pursuant to which foreign law generally "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."[16] The Preamble describes the Deemed Liability Rule as a "clarification" of the technical taxpayer rule.

> [T]he 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 income tax purposes even if another person has the obligation to remit the tax (subject to the above-referenced reservation for hybrid instruments and payments). [Emphasis added.]

With all due respect, the Preamble's characterization of the Deemed Liability Rule as a *clarification* of the technical taxpayer is not credible. Clearly, the purpose of the Deemed Liability Rule is to override, not clarify, the technical taxpayer rule. The Treasury and the IRS understandably wish to avoid the arguably inappropriate results reached under the existing regulations, and sanctioned in *Guardian Industries*, but their attempt to accomplish this objective while purporting to retain the technical taxpayer rule is unsuccessful.

As noted above, the Proposed Regulations also adopt a Combined Income Rule providing that "[i]f foreign tax is imposed on the combined income of two or more persons … 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."[17] This allocation rule applies even if, as in *Guardian Industries*, a foreign consolidated income tax regime imposes liability for the consolidated group's tax obligations solely on the parent of the group. In such circumstances, it is difficult to discern the basis for *considering* foreign law to impose legal liability on each member of the group with positive income for foreign tax purposes, except that it produces the desired result. Clearly, the purpose of the Combined Income Rule in such circumstances is to override, not clarify, the technical taxpayer rule.

The interaction of the Combined Income Rule and the Deemed Combination Rule is particularly noteworthy. As explained above, the Deemed Combination Rule provides that a foreign tax imposed on income earned through an RHE is *considered* to be imposed on the combined income of the RHE and the person who owns an interest in the RHE. This opens the door for the Combined Income Rule to allocate the foreign tax imposed on the "combined income" of an RHE and its owner entirely to the RHE by deeming the RHE to have sole legal liability by reason of its contribution of 100 percent of the foreign tax base.[18] Thus, the Proposed Regulations would deem an RHE to have sole legal liability for a foreign tax for which the RHE may have no legal liability, and would deem the owner of the RHE to have no legal liability for a foreign tax for which such owner may be solely liable.[19] A most curious result indeed!

Thus, the Proposed Regulations would deem an RHE to have sole legal liability for a foreign tax for which the RHE may have no legal liability, and would deem the owner of the RHE to have no legal liability for a foreign tax for which such owner may be solely liable.

The Preamble indicates that certain aspects of the Combined Income Rule "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." That may be, but either legal liability matters or it doesn't. If it does, then figuring out who is liable under foreign law really shouldn't be too much trouble.

Moreover, whether it is less burdensome to quantify the income (under foreign law) of each person to which the Combined Income Rule applies than to determine which persons have legal liability under the applicable foreign consolidated tax regime is doubtful. Indeed, the opposite may well be true. Each foreign tax regime may well need to be analyzed only once (until the law changes) to determine where legal liability lies, whereas the allocation of income (under foreign law) necessarily will need to be repeated separately for many taxpayers, for many tax years. The burden of making such allocations is eased somewhat by the As-Prepared Rule, but the administrability of that rule is significantly undercut by the need to locate and reverse certain related-party amounts under the Related-Party Disallowance Rule.

In a somewhat more revealing statement, the Preamble notes that "[t]his approach will not only reduce inappropriate foreign tax credit splitting but will also reduce administrative burdens on taxpayers and the IRS." This excerpt arguably confirms that the real purpose of the Combined Income Rule—and of

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the Proposed Regulations generally—is to avoid a result considered to be inappropriate. Any reduction in administrative burdens, on taxpayers or the IRS, would appear to be a secondary benefit at best.

Conclusion

Try as one might, it simply is not possible to view the above-described provisions of the Proposed Regulations as mere clarifications of the technical taxpayer rule. So, why then are the Treasury and the IRS serving up new wine in the same old bottle? Obviously, they are concerned about their ability to overtly abandon the technical taxpayer rule[20]; and this concern would appear to be well justified for at least two reasons.

First, there's the statute. Subject to a discrete number of limitations, Code Sec. 901 allows a foreign tax credit for all foreign income taxes "paid or accrued." A regulation that too transparently denies the foreign tax credit to a person who pays a foreign income tax, and who was the only one legally liable to pay that tax,[21] might be viewed as inconsistent with the statute and, consequently, invalid.

Second, even assuming that the technical taxpayer rule is not otherwise required under Code Sec. 901, the Supreme Court's holding in *Biddle* might well have foreclosed the possibility of adopting an alternative regulatory approach. Clearly, there is precedent for the view that, once an issue has been resolved by the courts, regulations that attempt to adopt a different but otherwise-permissible interpretation of the statute may in effect be disregarded, pursuant to the doctrine of *stare decisis*.

For example, in *Bankers Trust New York Corp.*,[22] the Court of Appeals for the Federal Circuit (the "Court") allowed Bankers Trust New York Corporation and its subsidiaries ("BT") to claim foreign tax credits for certain putative tax payments made to Brazil in 1980.[23] In so doing, the court essentially ignored a regulation that would have disallowed such credits, because that regulation conflicted with earlier case law.[24]

Consequently, it is not difficult to understand why the Treasury and the IRS would prefer to portray the Proposed Regulations as retaining (and clarifying) the technical taxpayer rule. Nevertheless, that is not the case. If finalized in their current form, the Proposed Regulations may or may not be upheld, but the government's attempt to avoid a challenge by characterizing the new rules a mere fine-tuning seems unlikely to succeed.

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Endnotes

1 *M.D. Biddle*, SCt, 38-1 USTC ¶9040, 302 US 573, 58 SCt 379.

2 Notably, Code Sec. 904 already provides a meaningful limitation. In the example above, the U.S. parent will be able to credit the foreign taxes paid only if it has sufficient foreign-source income (in the applicable basket).

3 *Guardian Industries Corp.*, FedCl, 2005-1 USTC ¶50,263, 65 FedCl 50.

4 For a more extensive discussion of *Guardian Industries*, *see* Howard J. Levine and Michael J. Miller, Anti-Deferral and Anti-Tax Avoidance, *Court of Claims Approves Foreign Tax Credit Planning Technique*, J.TAX'N GLOBAL TRANS., Summer 2005, at 5.

5 Reg. §1.901-2(f)(3).

6 Proposed Reg. §1.901-2(f)(1)(i).

7 Proposed Reg. §1.901-2(f)(1)(i) (emphasis added). An exception applies, however, to certain related-party hybrid payments under Proposed Reg. §1.901-2(f)(4).

8 Proposed Reg. §1.901-2(f)(2)(i) (emphasis added).

9 Proposed Reg. §1.901-2(f)(2)(ii).

10 *Id.*

11 Proposed Reg. §1.901-2(f)(2)(iii).

12 Proposed Reg. §1.901-2(f)(1)(iv)(A). However, the reference to amendments or adjustments presumably would reflect adjustments made by the applicable foreign tax authority as well as any adjustments made by the taxpayer.

13 Proposed Reg. §1.901-2(f)(1)(iv)(B). The Proposed Regulations reserve, however, with respect to certain related-party hybrid payments. *See* Proposed Reg. §1.901-2(f)(4). The Proposed Regulation is not expressly limited to related-party obligations, but the Preamble confirms that such a limitation was intended.

14 The Proposed Regulations also include a provision for allocating net losses taken into account for foreign tax purposes. Proposed Reg. §1.901-2(f)(1)(iv)(C). A mandatory allocation of net losses under applicable foreign law will be respected; but if foreign law does not provide for a mandatory allocation, then for purposes of the Proposed Regulations, a net loss shall be allocated *pro rata* among the other persons in the group in proportion to their respective incomes, as otherwise determined for foreign income tax purposes (subject to the other modifications of the Proposed Regulations).

15 Proposed Reg. §1.901-2(f)(1)(i).

16 Proposed Reg. §1.901-2(f)(1)(i) (emphasis added).

17 Proposed Reg. §1.901-2(f)(2)(i) (emphasis added).

18 The example above assumes that, for foreign tax purposes, the owner of the RHE earns no taxable income outside the RHE.

19 Presumably, it would not be surprising if the owner of the RHE were the only person liable for the foreign taxes attributable to the income of the RHE.

20 Notably, Congress has thus far failed to enact legislation specifically granting broad regulatory authority, notwithstanding several requests.

21 Where one person is obligated to make a payment, but another person actually makes the payment, the transaction generally is treated for tax purposes as a payment by the latter person to the former person and a payment by the former person of his, her, or its obligation. For example, if A pays B's real estate taxes as consideration for services performed by B for A, B should be viewed for tax purposes as having received a compensatory payment from A and as having used the funds so received to pay B's real estate taxes. This principle (which is confirmed by Proposed Reg. §1.901-2(f)(2)(v)) does not apply, however, where the foreign tax is paid by the person who is legally liable therefor.

Endnotes

[22] *Bankers Trust New York Corp.,* CA-FC, 2000-2 USTC ¶ 50,739, 225 F3d 1368, *rev'g,* 96-2 USTC ¶ 50,384, 36 FedCl 30.

[23] The amount of foreign tax that should be considered to have been paid is debatable, since 85 percent of the so-called tax, which was collected directly from the borrower through withholding, was immediately (if not simultaneously) returned to the borrower as a subsidy.

[24] The regulation at issue in *Bankers Trust* would have disallowed the foreign tax credit to the extent that any amount, determined by reference to the tax paid, is used to provide a direct or indirect subsidy to the taxpayer. For this purpose, the provision of a subsidy to a person who borrows funds from the taxpayer would be treated as an indirect subsidy to the taxpayer. In 1986, new Code Sec. 901(i) was enacted to incorporate the "anti-subsidy" rule set forth in that regulation, but this amendment was not applicable for the year at issue in *Bankers Trust*. For a more detailed discussion of *Bankers Trust, see* Peter A. Glicklich and Michael J. Miller, *Appeals Court Adheres To Precedent, Tells IRS That It's Too Late To Issue Regulations*, 48 CANADIAN TAX J. 6., at 1962 (2000).

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