



BDO Seidman, LLP
Accountants and Consultants

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Subject:

Proposed Regulations Issued Relating to “Technical Taxpayer Rule” for Foreign Tax Credits

International Tax Alert

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Date\Timing:

As indicated in its notice of hearing released August 4, 2006 (REG-124152-06), the IRS is requesting comments on proposed regulations affecting taxpayers that claim direct or indirect foreign tax credits.

Comments on the proposed regulations must be received by October 3, 2006. A public hearing is scheduled for October 13, 2006.

The proposed regulations would be effective for foreign taxes paid or accrued during taxable years beginning on or after January 1, 2007.

Affecting:

U.S. taxpayers claiming foreign tax credits under IRC § 901.

Background:

IRC § 901(a) generally allows U.S. taxpayers to claim a credit for foreign income taxes subject to various limitations. Treasury Regulation § 1.901-2(f) provides that the “person” which is liable for the tax under foreign law may claim the credit. Since the § 901 regulations were finalized in 1983, a number of court decisions have been rendered which have taken inconsistent positions on who the taxpayer is under the regulations. Likewise, the addition of the “Check-the-Box” regulations (Treas. Reg. §§ 301.7701-1 through -3) has raised questions on tax liability due to differing tax treatment of the same entity under U.S. and foreign tax law.

Proposed Revisions to Regulations:

Proposed Treas. Reg. § 1.901-2(f) is intended to clarify application of the existing rules by specifying that liability for income tax will be considered to be imposed on the person required to take such income into account for foreign tax purposes even if another person pays the tax or can be held liable for the tax. The proposed regulations also have specific rules with respect to consolidated groups, reverse hybrids, and hybrid entities.

Proposed Treas. Reg. § 1.901-2(f)(2) also address the tax liability of foreign consolidated groups including, groups with members that are not jointly and severally liable in the U.S. sense, groups that have a parent corporation with members being treated as branches, and groups in which some members have limited or no obligation for taxes. Proposed Treas. Reg. § 1.901-2(f)(2) makes clear the principle that foreign tax must be apportioned pro rata based on each member's relative share of net income as computed under foreign law.

Further, the proposed regulations would revise Treas. Reg. § 1.901-2(f) to provide that a reverse hybrid (i.e., an entity that is a partnership for foreign purposes but a corporate entity for U.S. tax purposes) is considered to have legal liability for foreign taxes imposed on the entity's owner in respect of the owner's share of the entity's income under foreign law. Thus, the proposed regulations could negatively impact the viability of the so-called "splitter" structures.

Finally, the proposed regulations would make clear that under the existing rules, the owner of an entity that is disregarded for U.S. tax purposes is considered to have the legal liability for foreign taxes paid by the disregarded entity.

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 issues are expected to be addressed in a forthcoming regulatory project.

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