NATIONAL FOREIGN TRADE COUNCIL, INC .

1625 K STREET, NW, WASHINGTON, DC 20006-1604

TEL: (202) 887-0278 FAX: (202) 452-8160

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Mr. Harry Hicks III
International Tax Counsel
U.S. Department of Treasury
1500 Pennsylvania Ave., NW, Room 3054
Washington, DC 20220

Dear Mr. Hicks:

I again wanted to thank you for meeting with representatives from NFTC member companies (the "NFTC") last November to discuss the separation of foreign taxes from related income. Thank you also for including your colleagues in that meeting. The NFTC appreciates your support in continuing this dialogue. The NFTC supports controlling the inappropriate separation of foreign taxes from income without compromising the simplicity and certainty currently afforded by the technical taxpayer rule.

Consolidated Returns: As stated in the NFTC's previous draft comments, there is no disagreement that the Service has the authority to issue regulations regarding foreign consolidated returns to address issues such as those in *Guardian Indus. Corp. v. U.S.*, 65 Fed. Cl. 50 (2005). *Biddle v. Commissioner*, 302 U.S. 573 (1938), did not deal with the case of the combined income of two or more parties, and the statute is silent on the issue.

Furthermore, the NFTC supports efforts to modify the original §1.901-2(f)(3) regulations to control the inappropriate separation of foreign taxes from related income by requiring the proportionate allocation of foreign taxes based on foreign tax principles. The NFTC believes that the elimination of the "joint and several" requirement from the afore-mentioned regulations will facilitate the implementation of a consistent tax allocation process applicable to all consolidated tax regimes.

Reverse Hybrids: As was discussed at the November meeting and in the draft comments offered at that time, there continues to be concern regarding the application of regulatory authority to reverse hybrids. Those comments are supplemented below. During the November meeting, it was suggested that the *National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 545 U.S. __, 125 S. Ct. 2688 (2005) decision might allow the Service to administratively overrule *Biddle*. A review of that decision did not change the NFTC's conclusion.

1. Regulatory Authority:
    a. The Code language to be interpreted is §901(b), which provides in pertinent part for foreign tax credits for "the amount of any income . . . taxes paid or accrued during the taxable year to any foreign country . . . ."
    b. In interpreting this statutory language, *Biddle* provides that the party who bears liability to pay the tax, applying U.S. concepts, is the party entitled to the credit for the taxes;

a. In the withholding tax context, applying U.S. concepts, the party liable for the tax is the party receiving the income even if the payor is the one who actually remits the tax;

b. In the typical reverse hybrid case, there is no question that there are two distinct persons involved for both U.S. and foreign purposes, the shareholder/partner and the corporation/partnership. Further, the legal liability to pay the tax is clearly on the shareholder/partner. In this situation, it appears questionable whether the Service could allocate the taxes paid by the shareholder/partner to the corporation/partnership without violating §901(b) and *Biddle*. As stated by *Biddle*, "Nor have [the U.S. revenue laws] treated as taxpayers those upon whom no legal duty to pay the tax is laid."

   i. Unlike in the case of consolidated returns, this is not a combined income case. In the typical reverse hybrid situation, only the income of the reverse hybrid is taxed, not the combined income of the reverse hybrid and the partner/shareholder. To allocate the income of the reverse hybrid (absent a §482 abuse) to the partner/shareholder disrespects the entity classification of the reverse hybrid. To allocate taxes for which the taxpayer/shareholder is liable to the reverse hybrid disrespects §901(b) and *Biddle*.

   ii. This is not a withholding tax collection situation where the party liable for the tax under U.S. concepts does not actually remit the tax. Under both U.S. (partnership) and foreign principles, the shareholder/partner both pays and is liable for the foreign tax.

   iii. To allocate taxes to the reverse hybrid, which neither paid nor was liable under U.S. or foreign principles for the tax would violate §901(b) and *Biddle*.

2. At the November meeting, the NFTC was asked the impact that *National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 545 U.S. __, 125 S. Ct. 2688 (2005), would have on their position regarding regulatory authority. A review of that decision did not result in a change regarding regulatory authority, as outlined below.

a. In *National Cable*, the Court held that: "A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion." While it did not specifically state in such terms, a reading of *Biddle* clearly shows that the Court thought that the statute was unambiguous. Thus, by its terms, *National Cable* does not apply.

b. In *National Cable*, the court in question was the Ninth Circuit Court of Appeals. It is not clear that the Supreme Court would apply the same rule to its own decisions. As noted by Justice Stevens in his concurring opinion, "That explanation [of why a court of appeals' interpretation of an ambiguous statute does not prevent a different interpretation by an agency] would not necessarily be

applicable to a decision by this Court that would presumably remove any pre-existing ambiguity."

c. The facts leading to the decision in *National Cable* are distinguishable from this situation. *National Cable* dealt with a relatively new statute (a 1996 amendment to the Communications Act of 1934) in which the Ninth Circuit made an interpretation in 2000 before the FCC addressed the issue by releasing an order in 2002. When the Ninth Circuit heard an appeal from the 2002 FCC order, it decided the case based upon its own 2000 interpretation. The Supreme Court was clearly troubled by the timing here, finding that allowing a judicial precedent to foreclose action by an agency "would mean that whether an agency's interpretation of an ambiguous statute is entitled to *Chevron's* deference would turn on the order in which the interpretations issue: If the court's construction came first, its construction would prevail, whereas if the agency's came first, the agency's construction would command *Chevron* deference." In the current situation, however, timing is not an issue as *Biddle* was decided 68 years ago.

d. *National Cable* does reiterate that an agency can change its own interpretations, and that an agency's inconsistency "is not a basis for declining to analyze the agency's interpretation under the *Chevron* framework." This does not mean that the agency can take a position that is also inconsistent with a Supreme Court decision.

e. While *Biddle* and §901(b) were written before taxpayers began using reverse hybrids to split foreign tax credits from associated income, that does not make §901(b) or *Biddle's* holding ambiguous -- both appear to apply in the reverse hybrid context. Congressional action is required if a statute needs to be updated to fit changing circumstances.

f. In the recent Tax Court decision in *Swallows Holdings, Ltd. v. Commissioner*, 126 T.C. No. 6 (Jan. 26, 2006), the Tax Court questioned whether *National Cable* applies to tax cases. It did not answer that question, but distinguished *National Cable* (for some of the same reasons presented here). It then went on to apply *National Muffler Dealers Ass'n v. U.S.*, 440 U.S. 472 (1979), the regulatory authority case normally applied to tax cases. That was the same conclusion presented in the previous NFTC draft comments, *i.e.*, that under *National Muffler*, it is questionable whether the Service has regulatory authority to address the reverse hybrid issue.

3. *Considerations for Reverse Hybrid Regulations:* The New York State Bar Association's "Report on Regulation Section 1.901-2(f)(3) and the Allocation of Foreign Taxes Among Related Persons", of April 5, 2005, proposes the allocation of taxes paid by a parent (for U.S. tax purposes) /partner (for foreign tax purposes) to its subsidiary/partnership. In this case, the departure from the technical taxpayer rule could create complex tax accounting issues, compounded by the fact that such arrangements often involve significant cross-border and/or third party ownership structures. Whereas cross-border ownership entails the applicability of multiple foreign tax regimes, and in many cases multiple currencies, tracking tax allocations during periods of third party

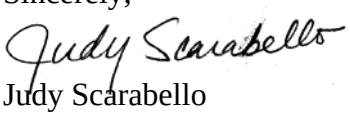
ownership could be particularly burdensome. With these potential difficulties in mind, please consider including the following in any proposed regulations:

1. Targeting any abuses as narrowly as possible;
2. The U.S. tax treatment of reimbursements and non-reimbursements of taxes between the reverse hybrid and its partners/shareholders;
3. The allocation of taxes where the reverse hybrid is treated differently by the jurisdictions of different partners, e.g., a reverse hybrid for a U.S. partner but a true partnership under the laws of a foreign partner; and
4. If taxes are to be allocated from all partners to the reverse hybrid entity, the determination of the foreign taxes paid by another partner where that tax liability will be affected by other tax attributes of that partner.

4. *Other Areas:* At the November meeting, the NFTC was asked to comment on the use of partnerships and hybrid instruments. There are no comments at this time.

Thank you again for the opportunity to provide this submission. Along with the NFTC members that are participating in this work, I look forward to continuing discussions on these and other matters.

Sincerely,



Judy Scarabello
Vice President for Tax Policy