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Client Alert

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Internal Revenue Service Issues Temporary and Final Treasury Regulations on Foreign Tax Credit Splitters

On February 14, 2012, the Internal Revenue Service (the "Service") published in the Federal Register proposed and temporary regulations (the "Section 909 Regulations") under Section 909 of the Internal Revenue Code (the "Code"), the foreign tax credit "splitter" legislation enacted on August 10, 2010. On December 6, 2010 the Service had released, in Notice 2010-92, 2010-52 I.R.B. 916 (the "Notice"), its first tranche of guidance under the provision. That Notice applied only to foreign taxes ("pre-2011 taxes") paid or accrued by a foreign corporation (a "Section 902 corporation") in which a domestic corporation (a "Section 902 shareholder") owns at least 10 percent of the voting stock in a taxable year (a "pre-2011 year") of the corporation beginning before January 1, 2011. With modifications, the Section 909 regulations extend the Notice's concepts to foreign taxes paid or accrued in later years by all taxpayers, not just Section 902 corporations.

Section 909 provides that if there is a "foreign tax credit splitting event" with respect to a foreign tax paid or accrued by a taxpayer or a Section 902 corporation, the tax is not taken into account for Federal income tax purposes (such as Code Sections 901 and 902 and the determination of earnings and profits ("E&P")) before the year in which the payor of the tax takes into account the "related income" (or, in the case of a Section 902 corporation, related E&P). A foreign tax credit splitting event occurs when a "covered person" (generally, a person related to, or connected through 10 percent ownership with, the payor of the tax) takes the related income into account. The suspended tax is taken into account (or recaptured) in the taxable year in which the payor of the tax or a Section 902 shareholder in the payor takes into account the related income (as computed under U.S. principles). The statute furnishes the Service with broad regulatory authority to implement the provision. It applies to taxes paid or accrued in a "post-2010 taxable year" (a taxable year other than a pre-2011 taxable year). It also applies, according to statutory language as interpreted by the Explanation of the Staff of the Joint Committee on Taxation (the "JCT Report"), to pre-2011 taxes for the purpose of applying the deemed paid foreign tax credit rules to dividends, deemed dividends, and Code Section 951 inclusions in a post-2010 taxable year.

The Section 909 Regulations follow the Notice in applying Section 909 only to foreign tax credit splitting events specified in the regulations. Notably, at least for now, the Service has refrained from treating as foreign tax credit splitting events certain transactions, elections, and allocations that it raised in the Notice as possible candidates for such treatment, viz., (a) the incorporation of a disregarded

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entity or hybrid partnership, (b) an inclusion in income under a foreign anti-deferral regime, (c) a transfer pricing adjustment, and (d) a split of taxes from income arising from a Section 338(g) election and other "covered asset acquisitions" ("CAAs") described in Section 901(m).* The preamble to the Section 909 Regulations cautions, however, that future guidance may set out other transactions or arrangements that give rise to a foreign tax credit splitting event. According to the preamble, such guidance would apply on a prospective basis only. The preamble mentions as one possibility a distribution treated as a withholding tax-triggering dividend for foreign purposes but as disregarded or as an excludible stock dividend for U.S. purposes.

On the same day that the Service published the Section 909 regulations, it also published guidance under two other Code provisions that address the separation of foreign tax from the related income. The Notice could have been read to suggest that the Service was considering finalizing proposed regulations issued in 2006 under Section 901, providing rules for determining the "technical" taxpayer of a foreign tax eligible for the credit in certain structures (the "Proposed Section 901 Regulations"), to address one type of foreign tax credit splitting event ("combined income splitters") addressed by the Notice. The Service's finalization of portions of the Proposed Section 901 Regulations on February 14 (the "Final Section 901 Regulations") has done just that. The Final Section 901 Regulations also address another type of splitter transaction (the "taxable year splitters") addressed by the Proposed Section 901 Regulations but not by the Notice. Finally, the Notice observed that allocations that meet the requirements of the Section 704(b) regulations relating to partnership items can result in allocations of a partnership's creditable foreign tax expenditures ("CFTEs") and related income to different partners. Although the Notice did not treat these allocations as foreign tax credit splitting events, both temporary Section 704(b) regulations issued as part of the same package as the Section 909 Regulations (the "Section 704(b) Regulations") and the Section 909 Regulations themselves, in their different ways and for different periods, prospectively eliminate the benefits of such allocations.

The Section 909 Regulations, the Final Section 901 Regulations, and the Section 704(b) Regulations, intricately interrelated at some points, address the same issue of splitting income from taxes and in several cases the same transactions. Thus, rather than address the regulations separately, the following guide is organized by type of splitter transaction. (<u>The matrix at the end of the alert summarizes the guide.</u>) The final two sections of this guide address an anti-abuse rule not in the Notice that the Section 909 Regulations include and rules relating to the operation of Section 909.

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* In the last case, a Section 338(g) election would ordinarily create differences between the timing of inclusions in or deductions from income for foreign tax purposes and accrual of the foreign tax on the one hand and the inclusion in or deductions from income for US purposes on the other. Section 901(m) would permanently disallow a credit, but not a deduction, for a portion of the foreign tax attributable to the timing difference. The preamble notes, however, that Section 901(m) may apply to foreign taxes paid or accrued in connection with a foreign tax credit splitting event, such as a Section 338(g) election with respect to the acquisition of an interest in a reverse hybrid. The preamble states that the Treasury and the Service are studying whether Section 909 should suspend a deduction for the tax that Section 901(m) denies as a credit in that case.

In several cases, this guide addresses pre-2011 taxes that both the Notice and the Section 909 Regulations exclude from the splitter regime altogether. These "qualifying pre-2011 taxes" include:

(a) any pre-2011 taxes paid or accrued by a person other than a Section 902 corporation

(b) any pre-2011 taxes paid or accrued by a Section 902 corporation that were not paid or accrued in connection with a "pre-2011 splitter arrangement" identified in the Section 909 Regulations;

(c) any pre-2011 taxes paid or accrued by a Section 902 corporation that were paid or accrued in connection with a pre-2011 splitter arrangement ("pre-2011 split taxes") identified in the Section 909 Regulations that were deemed paid under Section 902(a) or 960 on or before the last day of the Section 902 corporation's last pre-2011 taxable year;

(d) any pre-2011 tax paid or accrued by a Section 902 corporation if either the payor Section 902 corporation took the related income into account in a pre-2011 taxable year or a Section 902 shareholder of the relevant Section 902 corporation took the related income into account on or before the last day of the Section 902 corporation's last pre-2011 taxable year; and

(e) any pre-2011 split taxes paid or accrued by a Section 902 corporation in taxable years of such Section 902 corporation beginning before January 1, 1997.

Combined Income Splitters

Background

Like the United States, many foreign jurisdictions have combined income tax regimes under which the income and losses of commonly-owned corporations can be combined for purposes of income tax reporting. In these situations the issue arises of how to allocate the foreign taxes imposed on the combined income for purposes of the U.S. foreign tax credit rules.

Current regulations provide limited guidance on this issue. Treas. Reg. § 1.901-2(f)(1) provides generally that the person by whom tax is considered paid (*i.e.*, the "taxpayer") for purposes of the foreign tax credit rules is the "person on whom foreign law imposes legal liability for such tax" (the "unmodified technical taxpayer rule"). If foreign income tax is imposed on the combined income of two or more related persons and they are jointly and severally liable for the income 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. Treas. Reg. § 1.901-2(f)(3).

In some foreign jurisdictions, however, one member of the group (generally the parent) may be treated as solely liable for all taxes imposed on the combined income, or one or more group members might otherwise not be liable for the tax imposed on their income. In *Guardian Industries v. Commissioner*, 65 Fed Cl. 50 (2005), *aff'd,* 477 F.3d 1368 (Fed. Cir. 2007), the Court of Federal Claims found (and the Federal Circuit affirmed) that under Luxembourg domestic law the parent company of a Luxembourg combined group was solely responsible for the tax on the group's combined income, regardless of which entity earned the income. Accordingly, the U.S. owner of the parent company, a disregarded entity for U.S.

tax purposes, was entitled to a credit under Section 901 for the full amount of the tax paid on the combined income even though the income (as computed under U.S. principles) earned by the subsidiaries was not subject to current U.S. tax.

In response to *Guardian*, the Service in 2006 proposed new regulations under section 901 (the "Proposed Section 901 Regulations") which would have modified the technical taxpayer rule to provide that, if foreign tax is imposed on the combined income of two or more persons (for example, 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, regardless of which person is legally obligated to pay the tax under foreign law. Prop. Treas. Reg. § 1.901-2(f)(2) (2006). The Final Section 901 Regulations incorporate this rule. The following addresses the tax treatment of foreign taxes paid or accrued on combined income under the Section 909 Regulations and the Final Section 901 Regulations.

Taxes Paid or Accrued in Taxable Years Beginning Before January 1, 2011

Foreign Taxes Paid or Accrued by Persons That Are Not Section 902 Corporations and "Qualifying Pre-2011 Taxes" Paid by Section 902 Corporations. Such a tax is considered paid by the person that has legal liability for the tax under the unmodified technical taxpayer rule, even if such tax relates in part or in whole to income generated by another group member, unless such person and one or more other group members have joint and several liability for any portion of the tax, in which case such portion is allocated under the principles of the relevant foreign law among the relevant members based on each member's portion of the base of the tax.

As indicated above, "qualifying pre-2011 taxes" include taxes that were not paid or accrued in connection with a "pre-2011 splitter arrangement." One of the identified pre-2011 splitter arrangements applicable to taxes paid or accrued by a Section 902 corporation is a situation where foreign law imposes tax on the combined income of a group but the taxpayer did not allocate the tax on the combined income based on each member's share of the combined income included in the foreign base (a pre-2011 "combined group splitter"). However, the Section 909 Regulations do not require suspension of such pre-2011 combined group split taxes if the taxes of the Section 902 corporation fall into one of the other categories of qualifying pre-2011 taxes listed at the end of the introductory section of this alert.

Foreign Taxes Paid or Accrued by Section 902 Corporations That are Not "Qualifying Pre-2011 Taxes." The Section 909 Regulations provide that such taxes are removed from the Section 902 corporation's pools of post-1987 foreign income taxes. Such taxes are suspended as of the first day of the Section 902 corporation's first post-2010 taxable year until the related income is taken into account under the rules prescribed by the Section 909 Regulations. Thus, if foreign law imposed tax on the combined income of a group but the taxpayer, a Section 902 corporation and a member of the group, paid tax on income allocable to another member the group, the tax would be subject to the suspension and recapture mechanism of the Section 909 rules unless it otherwise qualified as a "qualifying pre-2011 tax."

Taxes Paid or Accrued in Taxable Years Beginning after December 31, 2010 and on or Before February 14, 2012

The unmodified technical taxpayer rule applies to all taxpayers except where (i) foreign law imposed the tax on the combined income of a group but the taxpayer did not allocate the tax on the combined income based on each member's share (as determined under foreign law) of the consolidated taxable income included in the foreign tax base or (ii) the tax was part of another splitter arrangement specified in the Section 909 Regulations. In the excepted situation, the tax is suspended (and, in the case of a Section 902 corporation, removed from the post-1987 foreign income taxes pool) and subject to recapture under the Section 909 rules unless the taxpayer elects to apply the Final Section 901 Regulations.

By electing to apply the Final Section 901 Regulations, the taxpayer must allocate tax imposed on "combined income" on a pro rata basis in proportion to each person's portion, as determined under foreign law and the Final Section 901 Regulations, of the "combined income". (Note that this rule requires pro rata allocation, not, like the determination of each member's share of the foreign tax base described in the preceding paragraph, allocation based on the allocation principles of foreign law.) The regulations provide that combined income is 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. In the absence of a return, the person's income is determined from the books of account regularly maintained for purposes of computing its income for foreign tax purposes.

The pro rata portion is determined by giving effect to payments and accrued amounts of interest, rents, royalties, and other amounts between persons whose income is included in the combined base to the extent such amounts would be taken into account in computing the separate taxable incomes of such persons under foreign law for purposes of determining each person's portion of the combined income. Also, the treatment of a payment is determined under foreign law. Thus, for example, interest accrued by one group member with respect to an instrument held by another member that is treated as debt for foreign tax purposes but as equity for U.S. Federal income tax purposes would be considered income of the holder and would reduce the income of the issuer. This situation could nevertheless give rise to a foreign tax credit splitting event covered by the 909 Regulations.

A comment to the Proposed Section 901 Regulations suggested that combined income subject to preferential tax rates should be allocated only to group members with that type of income, in order to more closely match the tax with the related income. The Service agreed. The Final Section 901 Regulations provide that, if preferential tax rates, deductions, or credits apply to certain segments of combined income, the foreign tax imposed on that segment of income must be allocated separately to the group member(s) that earned the preferred income segment.

The Final 901 Regulations also add illustrations clarifying that foreign tax is not considered to be imposed on combined income solely because foreign law: (1) reallocates income from one person to a related person under foreign transfer pricing provisions; (2) requires a person to take into account a share of taxable income of an entity that is a partnership or other fiscally transparent entity for foreign tax law purposes; or (3) requires a person to take all or part of the income of an entity that is a corporation for U.S. tax purposes into account because foreign law treats the entity as a branch or fiscally transparent entity (a reverse hybrid). It should be noted, however, that some of these situations may give rise to a splitter event covered by the Section 909 Regulations.

The Final Section 901 Regulations also contain technical rules prescribing how to make foreign income and tax allocations in various scenarios (e.g., when one or more group members is in a loss position).

Taxes Paid or Accrued in Taxable Years Beginning After February 14, 2012

All taxpayers must apply the Final Section 901 Regulations. Thus, taxpayers must allocate taxes on combined income among group members based on their pro rata shares of the underlying income. Since such taxes would not be split from the related income, the Section 909 Regulations should not apply to taxes paid or accrued in such periods.

Taxable Year Splitters

Background

Consider a typical hybrid entity that is classified as a partnership for U.S. tax purposes but is regarded as a corporation for foreign tax purposes. Changes in the entity's ownership can cause the partnership to terminate for U.S. tax purposes. For instance, a sale or exchange of 50 percent or more of the total interests in the partnership can result in the deemed termination of the existing partnership under section 708(b)(1)(B) and the creation of a "new" partnership for U.S. tax purposes. Similarly, the consolidation of the entity's ownership interests within a single person or entity can cause the partnership to terminate and convert into a disregarded entity for U.S. tax purposes.

In both cases, the termination results in a closing of the existing partnership's taxable year. For foreign tax purposes, however, the entity generally remains in existence and continues without interruption. If the entity's foreign tax liability does not become due and payable until the end of its foreign taxable year, the new partnership or the owner of the resulting disregarded entity (as the case may be) would be treated as paying or accruing the entire foreign tax liability under the unmodified technical taxpayer rule, even though it existed for U.S. tax purposes for only a portion of the foreign taxable year. The terminating partnership, on the other hand, would accrue a portion of the entity's foreign taxable income for the taxable year but would not be treated as paying any portion of the corresponding foreign taxes. These circumstances could conceivably fall within the definition of a foreign tax credit splitting event under Section 909. The same type of result could potentially arise in a variety of other similar circumstances such as when a disregarded entity makes a mid-year election to be classified as a corporation for U.S. tax purposes.

The unmodified technical taxpayer rule was promulgated in 1983. In 2006, four years before the enactment of Section 909, the Service issued the Proposed Section 901 Regulations in part to modify the technical taxpayer rule to address certain fact patterns similar to those described above. The promulgation of the check-the-box regulations under section Treas. Reg. § 301.7701-1 through -3 in large part drove the need for additional guidance.

In the preamble to the Section 909 Regulations, the Service acknowledges that "[c]ertain changes of ownership involving related parties could be treated as a foreign tax credit splitting event under section 909." Rather than doing so, however, the Service has addressed the issue through the Final Section 901 Regulations, identical to the Proposed Section 901 Regulations in all material relevant respects. In general, these regulations provide that, when the taxable year of a hybrid entity terminates for U.S. tax purposes but continues for foreign tax purposes, foreign taxes that the entity pays or accrues must be allocated between the terminating entity and its successor.

Taxes Paid or Accrued in Taxable Years Beginning on or Before February 14, 2012

The unmodified technical taxpayer rule applies, even if under the technical taxpayer rule, as modified by the Final Section 901 Regulations, another person is the taxpayer in such person's year beginning after February 14, 2012. The Final Section 901 Regulations do not permit taxpayers to apply the Final Section 901 Regulations in earlier periods.

Taxes Paid or Accrued in Taxable Years Beginning After February 14, 2012

Foreign taxes paid or incurred by a hybrid entity that undergoes a mid-year termination must be allocated between the terminating entity and its successor in accordance with the principles of Treas. Reg. § 1.1502-76(b). The Final Section 901 Regulations provide the following rules for allocating foreign taxes:

(i) If the U.S. taxable year of a partnership closes for all partners due to a termination of the partnership under Section 708(b)(1)(A) (the cessation of the partnership's business, financial operation, or venture) and the foreign taxable year of the partnership does not close, foreign taxes paid or accrued with respect to the foreign taxable year in which the termination occurs must be allocated between the terminating partnership and its successors or assigns.

(ii) If, as a result of a change in ownership, a partnership becomes a disregarded entity for U.S. tax purposes and the entity's foreign taxable year does not close, foreign tax paid or accrued by the owner of the disregarded entity with respect to the foreign taxable year must be allocated between the partnership and the owner of the disregarded entity.

(iii) If the U.S. taxable year of a partnership closes for all partners due to a termination of the partnership under section 708(b)(1)(B) (a sale or exchange of 50 percent or more of the total interest in partnership capital and profits within a 12-month period) and the foreign taxable year of the partnership does not close, then foreign taxes paid or accrued by the new partnership with respect to the foreign taxable year in which the termination occurs must be allocated between the terminating partnership and the new partnership.

(iv) If there is a change in the ownership of a disregarded entity during the entity's foreign taxable year and the change does not result in the a closing of the disregarded entity's foreign taxable year, foreign taxes paid or accrued for the taxable year must be allocated between the transferor and transferee.

Like the Proposed Section 901 Regulations, the Final Section 901 Regulations require allocations of foreign taxes to be made in accordance with the principles of Treas. Reg. § 1.1502-76(b) (generally pro rata between the U.S. taxable years based on the number of days in each). The preamble notes that at least one commenter recommended that foreign taxes be allocated under the principles of Sections 706 and 708 based on a closing of the books, rather than under the allocation principles of Treas. Reg. § 1.1052-76(b). The commenter suggested that apportioning foreign taxes in the same manner as taxable income would result in more consistent matching of foreign taxes and income. Arguably, such an approach would be consistent with the very purpose of Section 909. Nevertheless, the Service ultimately decided not to adopt this proposal on the ground that the administrative and compliance costs associated with a closing of the foreign tax books would be too burdensome.

Although the Final Section 901 Regulations provide a considerable amount of guidance on ownership changes involving reverse hybrid entities and certain disregarded entities, the regulations do not specifically address the situation in which a disregarded entity makes a mid-year election to be treated as a corporation for U.S. tax purposes. Like the scenarios discussed above, such an election has the potential to separate foreign taxes from related income because the "newly" formed corporation would be treated as paying all foreign taxes due and payable for the taxable year but would accrue only a portion of the related income for U.S. tax purposes. Given the rather specific nature of the newly-issued regulations, taxpayers could potentially take the position that the Final Section 901 Regulations simply do not apply to these types of transactions and, therefore, foreign taxes are not allocated between the newly-formed corporation and its shareholder. Although Section 909 could potentially apply to these taxes, the transaction apparently does not give rise to a foreign tax credit splitting event under the Final Section 909 Regulations although, as indicated, the Notice specifically identified this transaction as one that might be treated as a foreign tax credit splitting event in future guidance. Thus, the exclusion of this transaction from both regimes seems to have been deliberate.

Reverse Hybrid Splitters

Background

A reverse hybrid entity is an entity that is disregarded or treated as a partnership for foreign tax purposes but is considered a corporation for U.S. federal tax purposes. This treatment may arise from an election by the entity to be treated as a corporation for U.S. purposes under the check-the-box rules under Treasury Regulation § 301.7701-3.

The use of reverse hybrid entities in the foreign tax credit context was first addressed in *Abbot Laboratories International Co.* v. *U.S.*, 160 F. Supp. 321 (N.D. Ill. 1958), *aff'd per curiam*, 267 F.2d 940 (7th Cir. 1959) ("*Abbot Laboratories*"). In that case, the taxpayer, a U.S. corporation, sought a credit for taxes paid to the governments of Colombia and Argentina with respect to its interest in *sociedades de responsibilidad limitada* ("SRLs") in those countries. Under U.S. law, the SRLs qualified as corporations, but under Colombian and Argentine law, the SRLs were treated as fiscally transparent for purposes of the taxes imposed. The taxpayer argued that, because it was primarily liable for the taxes under foreign law, it should be entitled to a direct foreign tax credit. The Court, however, held that the technical taxpayer of the foreign taxes did not turn solely on the legal incidence of the taxes under the foreign law. Instead, because the taxes were actually paid out of the undistributed profits of the SRLs pursuant to an agreement between them and the taxpayer, and because the taxpayer had not received any distributions from the SRL for which it could be deemed to have paid the foreign taxes, the court held that the taxpayer did not actually pay the foreign taxes and was therefore not entitled to a credit.

The Service considered a similar situation in Revenue Ruling 72-197, 1972-1 C.B. 215. It addressed the treatment of a U.S. entity that was recognized as a corporation for U.S. Federal tax purposes but disregarded as an entity separate from its owners for foreign tax purposes. Because foreign law disregarded the entity, its U.S. citizen shareholders were liable for the foreign tax on the entity's income. The Service decided that, because the tax was paid or accrued by the shareholders in the entity, the entity itself could not claim a foreign tax credit under Section 901 for the amount paid by its shareholders. Instead, the shareholders themselves were entitled to the credit.

Based on the ruling and the unmodified technical taxpayer rule, U.S. taxpayers could claim credits for foreign taxes imposed on a reverse hybrid's income without including the income for U.S. tax purposes. The 2006 Proposed Regulations, if finalized, would have prevented this result by treating the reverse hybrid entity as if it had paid the full amount of foreign tax allocated to the income it generated. The Section 909 Regulations, however, instead address the issue through the tax suspension and recapture mechanism of the splitter rules.

Taxes Paid or Accrued in Taxable Years Beginning Before January 1, 2011

Foreign Taxes Paid or Accrued by Persons That Are Not Section 902 Corporations and "Qualifying Pre-2011 Taxes" Paid by Section 902 Corporations. Such a tax is considered paid by the person that has legal liability for the tax under the unmodified technical taxpayer rule, even if such tax relates at least in part to income generated by a reverse hybrid that the taxpayer does not take into account.

As indicated above, "qualifying pre-2011 taxes" include taxes that were not paid or accrued in connection with a "pre-2011 splitter arrangement." One of the identified pre-2011 splitter arrangements is a situation where the taxes are paid or accrued by a Section 902 corporation with respect to income of a reverse hybrid entity that is a covered person. The Section 909 Regulations do not, however, require suspension of such pre-2011 taxes if the taxes fall into one of the other categories of qualifying pre-2011 taxes listed at the end of the introductory section of this alert.

Foreign Taxes Paid or Accrued by Section 902 Corporations That are Not "Qualifying Pre-2011 Taxes." The Section 909 Regulations provide that such taxes are removed from the Section 902 corporation's pools of post-1987 foreign income taxes and suspended as of the first day of the Section 902 corporation's first post-2010 taxable year. Thus, if a Section 902 corporation paid or accrued tax with respect to income of a reverse hybrid that was a covered person and the tax did not otherwise qualify as a "qualifying pre-2011 tax," the tax would be subject to the suspension and recapture mechanism of the Section 909 splitter rules.

Taxes Paid or Accrued in Taxable Years Beginning After December 31, 2010

All taxpayers are potentially subject to the Section 909 Regulations. Thus, if any person pays or accrues a tax with respect to income of a reverse hybrid that is a covered person, the tax would be subject to the suspension and recapture mechanism of the Section 909 splitter rules.

Hybrid Instrument Splitters

Background

As recognized by the Notice and now by the Section 909 Regulations, hybrid instruments may split foreign tax from the related income with advantages for the taxpayer. In a variation of an example provided by the legislative history, U.S. Corp., a domestic corporation, wholly owns CFC1, a country A corporation, which in turn wholly owns CFC2, a country A corporation. CFC2 is engaged in an active business that generates $100 of income. CFC2 issues an instrument to CFC1 that is treated as equity for U.S. tax purposes but as debt for foreign tax purposes. Under the terms of the hybrid instrument, CFC2 accrues (but does not pay currently) interest to CFC1 equal to $100. As a result, CFC2 has no income for country A tax purposes, while CFC1 has $100 of income, which is subject to country A tax at a 30 percent rate. For U.S. tax purposes, CFC2 still has $100 of E&P (the accrued interest is ignored since the United States views the hybrid instrument as equity), while CFC1 has paid $30 of foreign taxes. Assume that CFC1 has only $20 of E&P. The shift in the incidence of the tax from CFC2 to CFC1 means that U.S. Corp. can access the $30 of foreign tax without any residual U.S. tax and with the opportunity to use the great bulk of the tax to offset U.S. tax on unrelated foreign income. Instruments treated as debt for U.S. but equity for foreign purposes present similar opportunities.

Taxes Paid or Accrued in Taxable Years Beginning Before January 1, 2011

Foreign Taxes Paid or Accrued by Persons That Are Not Section 902 Corporations and "Qualifying Pre-2011 Taxes" Paid by Section 902 Corporations. The Section 909 Regulations do not remove such taxes from a Section 902 corporation's pools of post-1987 foreign income taxes or suspend the crediting of the tax by a U.S. person. As indicated above, "qualifying pre-2011 taxes" include taxes that were not paid or accrued in connection with a "pre-2011 splitter arrangement." Two of the identified pre-2011 splitter arrangements are situations where (a) the issuer of an instrument treated as equity for U.S. and debt for foreign purposes (a "U.S. equity hybrid instrument") is a covered person with respect to a Section 902 corporation that is the owner of the instrument and (b) the owner of an instrument treated as debt for U.S. and equity for foreign purposes (a "U.S. debt hybrid instrument") is a covered person with respect to a Section 902 corporation that is the issuer of the U.S. debt hybrid instrument. The Section 909 Regulations do not, however, require suspension of such pre-2011 taxes if the taxes fall into one of the other categories of qualifying pre-2011 taxes listed at the end of the end of the introductory section of this alert.

Foreign Taxes Paid or Accrued by Section 902 Corporations That are Not "Qualifying Pre-2011 Taxes." The Section 909 Regulations provide that such taxes are removed from the Section 902 corporation's pools of post-1987 foreign income taxes and suspended as of the first day of the Section 902 corporation's first post-2010 taxable year. Thus, the portion of the pre-2011 taxes paid or accrued by the owner with respect to the amounts on a U.S. equity hybrid instrument that are deductible by the issuer as interest for foreign purposes but that do not give rise to income for U.S. purposes is removed from the taxes pool and subject to the suspension and recapture mechanism. The pre-2011 taxes subject to this treatment equal the total amount of the foreign taxes paid by the Section 902 corporation, reduced by the amount of taxes that would have been paid if the Section 902 corporation had not been subject to tax on the amount paid as interest on the U.S. equity hybrid instrument. Similarly, the portion of the pre-2011 taxes paid or accrued by the issuer equal to the taxes paid by the issuer on the income that would have been offset by the interest paid to the holder on a U.S. debt hybrid instrument, if that interest had been deductible for foreign tax purposes, is removed from the taxes pool and subject to the suspension and recapture mechanism.

Taxes Paid or Accrued in Taxable Years Beginning After December 31, 2010 and Before January 1, 2012

Taxes paid or accrued by any person that is a holder of a U.S. equity hybrid instrument issued by a covered person or that is an issuer of a U.S. debt hybrid instrument held by a covered person in the circumstances described in the previous section for taxes paid in prior taxable years by a holder or issuer, respectively, that is a Section 902 corporation are subject to the suspension and recapture mechanism of the Section 909 rules.

Taxes Paid or Accrued in Taxable Years Beginning After December 31, 2011

Taxes paid or accrued by any person that is a holder of a U.S. equity hybrid instrument issued by a covered person or that is an issuer of a U.S. debt hybrid instrument held by a covered person in the circumstances described in the second preceding section for taxes paid in prior taxable years by a holder or issuer, respectively, that is a Section 902 corporation are subject to the suspension and recapture mechanism of the Section 909 rules. The regulations expand the definition of a U.S. equity hybrid instrument, however, to include an instrument that is treated as debt or that gives rise to deductible payments for foreign taxes purposes. As an example, the preamble describes an instrument pursuant to which the issuer is treated as making payments that are deductible as notional interest payments for foreign tax purposes.

Group Relief/Loss-Sharing Splitter Arrangements

Background

A foreign group relief or other loss-sharing regime allows one entity in the group with a loss to transfer such loss to one or more members of the group to offset the receiving member’s (or members’) income. Both the Notice and the Section 909 Regulations treat certain group relief and other loss-sharing regimes as splitter arrangements. Although Section 909 itself was silent with respect to such situations, the JCT Explanation to the statute specifically mentioned “group relief” as an area in which it was anticipated that the Service may provide guidance regarding the “proper application” of Section 909.

The application of the Section 909 Regulations to group relief arrangements varies depending upon when the relevant taxes were paid or accrued.

Taxes Paid or Accrued in Taxable Years Beginning Before January 1, 2011

Foreign Taxes Paid or Accrued by Persons That Are Not Section 902 Corporations and "Qualifying Pre-2011 Taxes" Paid by Section 902 Corporations. Such a tax is considered paid by the person that has legal liability for the tax under the unmodified technical taxpayer rule.

As indicated above, "qualifying pre-2011 taxes" include taxes that were not paid or accrued in connection with a "pre-2011 splitter arrangement." One of the identified pre-2011 splitter arrangements is a situation in which a foreign group relief or other loss-sharing regime permits an entity with a loss to be used to offset, for foreign tax purposes, the income of one or more other entities. The Section 909 Regulations do not, however, require suspension of such pre-2011 split taxes if the taxes of the Section 902 corporation fall into one of the other categories of qualifying pre-2011 taxes listed at the end of the introductory section to this alert.

Foreign Taxes Paid or Accrued by Section 902 Corporations That are Not "Qualifying Pre-2011 Taxes." Taxes paid or accrued by a Section 902 corporation and that arise from group relief or other loss-sharing regimes are subject to the suspension and recapture rules of the Section 909 Regulations only in the relatively narrow context involving a disregarded debt instrument used to split taxes from the related income for foreign purposes.

In this regard, the Section 909 Regulations incorporate the Notice's rule on group relief/loss sharing verbatim with essentially no changes. Accordingly, a foreign group relief or other loss-sharing regime exists when one entity with a loss permitted the loss to be used to offset the income of one or more other entities (a "shared loss") only where the following three conditions were met:

(a) There is an instrument that is treated as indebtedness under the laws of the jurisdiction in which the issuer is subject to tax and that is disregarded for U.S. Federal income tax purposes (a "disregarded debt instrument").

Examples of a disregarded debt instrument include a debt obligation between (1) two disregarded entities that are owned by the same Section 902 corporation, (2) two disregarded entities that are owned by a partnership with one or more partners that are Section 902 corporations, (3) a Section 902 corporation and a disregarded entity that is owned by that Section 902 corporation, or (4) a partnership in which the Section 902 corporation is a partner and a disregarded entity that is owned by such partnership.

(b) The owner of the disregarded debt instrument pays a foreign income tax attributable to a payment or accrual on the instrument.

(c) The payment or accrual on the disregarded debt instrument gives rise to a deduction for foreign tax purposes and the issuer of the instrument incurs a loss (at least in part attributable to the deduction) that is taken into account under foreign law by one or more entities that are covered persons with respect to the owner of the instrument (a "shared loss").

In situations in which the three conditions described above are present taxes paid or accrued by the Section 902 corporation owner of the disregarded debt instrument with respect to amounts paid or accrued on the instrument (up to the amount of the shared loss) are suspended.

This rule can be illustrated through an example. The United Kingdom has a group relief system that, when applicable, allows related companies to surrender losses to each other. USP, a U.S. corporation, wholly owns UK-1, a U.K. company treated as a corporation for U.S. Federal income tax purposes. UK-1, in turn, wholly owns UK-2, a U.K. company treated as a disregarded entity for U.S. Federal income tax purposes, and UK-3, a U.K. company treated as a corporation for U.S. Federal income tax purposes. UK-1 extends a loan to UK-2, which is treated as indebtedness for U.K. purposes but is disregarded for U.S. Federal income tax purposes. UK-2 pays 100 pounds of interest on the loan to UK-1. UK-1 includes the 100 pounds of interest in income for U.K. tax purposes (its only income for the year), and pays U.K. tax on such income. UK-2, in turn, deducts the interest payments made to UK-1 for U.K. tax purposes. UK-2 has income of 50 pounds in Year 1, but interest expense of 100 pounds in the same year, resulting in a net loss of 50 pounds for Year 1. UK-3 has 50 pounds of income. UK-2 surrenders its loss to UK-3, fully offsetting UK-3's income with the consequence that UK-3 does not have any U.K. tax liability. In this example, a foreign tax credit splitting arrangement arises because (i) there is a disregarded debt instrument between UK-1 and UK-2, (ii) UK-1 pays a foreign income tax with respect to the interest on the disregarded debt instrument, (iii) UK-2's payment of such interest gives rise to a deduction, and (iv) UK-2 incurs a shared loss attributable to this deduction that is taken into account under U.K. law by UK-3, a covered person with respect to UK-1. Conceptually, the tax paid by UK-1 is split from the income derived by UK-3 that would have been subject to U.K. tax had UK-2 not surrendered its shared loss to UK-3. Note that the separation of tax from the income *for foreign purposes*, not the separation of the tax from the income for U.S. tax purposes, results in the splitter. In contrast, the split of tax from income for U.S. purposes (such as the hybrid transaction splitters) results in a splitter in at least some of the other situations.

The Section 901 Regulations had no effect on other group relief splitting arrangements that did not involve disregarded debt instruments. Altering the facts of the example above slightly, assume instead that there is no loan between UK-1 and UK-2. Further, in Year 1, UK-1 and UK-3 each have income of 100 pounds, and UK-2 has a loss of 100 pounds. UK-2 elects to surrender its loss to UK-3, so UK-3 has no net income for Year 1. Assuming a 30 percent tax rate, UK-1 pays 30 pounds in tax in Year 1. For U.S. Federal income tax purposes, UK-2's 100 pound loss is treated as incurred by UK-1 because UK-2 is a disregarded entity of UK-1. Thus, in Year 1, UK-1 has no income for U.S. Federal income tax purposes because its 100 pounds of income is offset by UK-2's 100 pound loss. If UK-2 had instead surrendered its loss to UK-1, UK-1 also would have had no income for U.K. purposes, and UK-1 would not have incurred any U.K. tax liability. By choosing to surrender its loss to UK-3, UK-1 still has no income for U.S. Federal income tax purposes but instead has 30 pounds of U.K. tax liability. Thus, the taxpayer would have effectively split its taxes in such a situation without falling within the scope of the Section 909 Regulations.

Taxes Paid or Accrued in Taxable Years Beginning After December 31, 2010 and Before January 1, 2012

The rules that apply to Section 902 corporations in earlier taxable years apply to all taxpayers.

Taxes Paid or Accrued in Taxable Years Beginning After December 31, 2011

The same rules, which encompass a broader group of group relief and loss-sharing situations than the rules for earlier taxable years, apply to all taxpayers.

Under the Section 909 Regulations, a foreign group relief or other loss-sharing regime is considered a loss-sharing splitter arrangement to the extent that a shared loss of a U.S. combined income group could have been used to offset income of that group ("usable shared loss") but is used instead to offset income of another U.S. combined income group. A "U.S. combined income group" means an individual or a corporation and all entities, including fiscally transparent entities, that for U.S. Federal income tax purposes combine any of their respective items of income, deduction, gain, or loss with the income, deduction, gain, or loss of such individual or corporation.

A U.S. combined income group can arise, for example, as a result of an entity's being disregarded or, in the case of a partnership or hybrid partnership and a partner, as a result of the allocation of income or any other item of the partnership to the partner. For purposes of this definition, a branch is treated as an entity, and all members of a U.S. affiliated group of corporations that file a consolidated return are treated as a single corporation. A U.S. combined income group may consist of a single individual or corporation and no other entities, but cannot include more than one individual or corporation. An entity can be a member of more than one U.S. combined group.

Except as otherwise provided in this provision, the income of a U.S. combined income group is the aggregate amount of taxable income recognized or taken into account for foreign tax purposes by those members that have positive taxable income for foreign tax purposes. Rules are provided for allocating income to U.S. combined groups of an entity that is a member of more than one.

A "shared loss" for this purpose is a loss of one entity for foreign tax purposes that, in connection with a foreign group relief or other loss-sharing regime, is taken into account by one or more entities. The amount of shared loss of a U.S. combined income group is generally the sum of the shared losses of all members of the U.S. combined income group. The Section 909 Regulations provide that a shared loss is allocated under rules similar to the rules regarding the allocation of income of a U.S. combined income group.

The Section 909 Regulations provide that split taxes from a loss-sharing splitter arrangement are the foreign income taxes paid or accrued by a member of the U.S. combined income group with respect to income equal to the amount of the "usable shared loss" of that group that offsets income of another U.S. combined income group. The related income with respect to such split taxes is an amount of income of the individual or corporate member of the U.S. combined group equal to the amount of income of that U.S. combined income group that is offset by the usable shared loss of another U.S. combined income group. Under the Section 909 Regulations, a foreign group relief or other loss-sharing regime will be found to exist when an entity may surrender its loss to offset the income of one or more other entities. Like the rules relating to taxes paid or accrued in taxable years beginning before January 1, 2012, these rules consider a splitter event to have occurred where the tax is separated from the related income for foreign tax purposes. A foreign group relief or other loss-sharing regime does not include (i) an allocation of loss of a partnership or other fiscally transparent entity for foreign tax purposes, or (ii) regimes in which foreign tax is imposed on combined income (such as a foreign consolidated regime).

The Section 909 Regulations offer several examples of the operation of the rules related to loss-sharing splitter arrangements. In one example, USP, a domestic corporation, wholly owns CFC1, a country A corporation. CFC1, in turn, wholly owns CFC2 and CFC3, both country A corporations. CFC2, in turn, wholly owns DE, an entity organized in country A that is treated as a corporation for country A purposes and as a disregarded entity for U.S. Federal income tax purposes. Country A has a loss-sharing regime under which a loss of any of the aforementioned foreign entities may be used to offset the income of one or more of the other foreign entities. Country A imposes a 30 percent income tax on country A corporations.

The example provides that in year 1 CFC1 has no income, CFC2 has income of 50u, CFC3 has income of 200u, and DE has a loss of 100u (with "u" representing country A's currency). The group decides to use DE's 100u loss to offset 100u of CFC3's income. As a result, CFC3 has income of 100u (200u less the 100u shared loss) on which it pays 30u of country A tax (100u times the 30 percent tax rate). CFC2 is left with 50u of income on which it pays 15u of country A tax (50u times the 30 percent tax rate).

For U.S. Federal income tax purposes, the loss sharing with CFC3 is not taken into account. Because DE is a disregarded entity, DE's 100u loss is taken into account by CFC2 and reduces CFC2's E&P for U.S. Federal income tax purposes. Thus, before application of Section 909, CFC2 would have a loss of 65u for E&P purposes (50u of income less the 15u of taxes paid less the 100u loss of DE). CFC2 would further have the U.S. dollar equivalent of 15u of foreign taxes added to its post-1986 foreign income taxes pool. Likewise, before application of Section 909, CFC3 would have E&P of 170u (200u of income less the 30u of taxes paid) and the dollar equivalent of 30u of foreign taxes added to its post-1986 foreign income taxes pool.

There are three U.S. combined income groups: (i) CFC2 and DE, (ii) CFC1, and (iii) CFC3. The income of the CFC2 U.S. combined income group is 50u, and the income of the CFC3 U.S. combined income group is 200u. The shared loss of the CFC2 U.S. combined income group is the 100u loss incurred by DE, but the "usable shared loss" is only 50u, the amount of the group's shared loss that could have otherwise offset CFC2's 50u of country A taxable income.

There is a splitter arrangement because the 50u usable shared loss of the CFC2 U.S. combined income group was used instead to offset income of CFC3, which is in a different U.S. combined income group. The split taxes in this case would be the 15u of country A taxes paid by CFC2 on 50u of income. The related income in this case is the 50u of CFC3's income that equals the amount of income of the CFC3 U.S. combined income group that was offset by the usable shared loss of the CFC2 U.S. combined income group.

It remains to be seen whether the Service's treatment of certain group relief arrangements as foreign tax credit splitting events will lead to conflicts with one of the fundamental requirements for claiming a foreign tax credit – the compulsory payment rule. Under the compulsory payment rule, a taxpayer is denied a foreign tax credit to the extent that a taxpayer could have reduced its liability for tax under foreign law by exhausting all effective and practical remedies, such as availing itself of any tax treaty benefits. The Service's decision to expand the instances in which a taxpayer's use of group relief will result in a foreign tax credit splitting event could discourage taxpayers from using the benefits of group relief to reduce their foreign tax liability, which would seem to cut against the mandate of the compulsory payment rule.

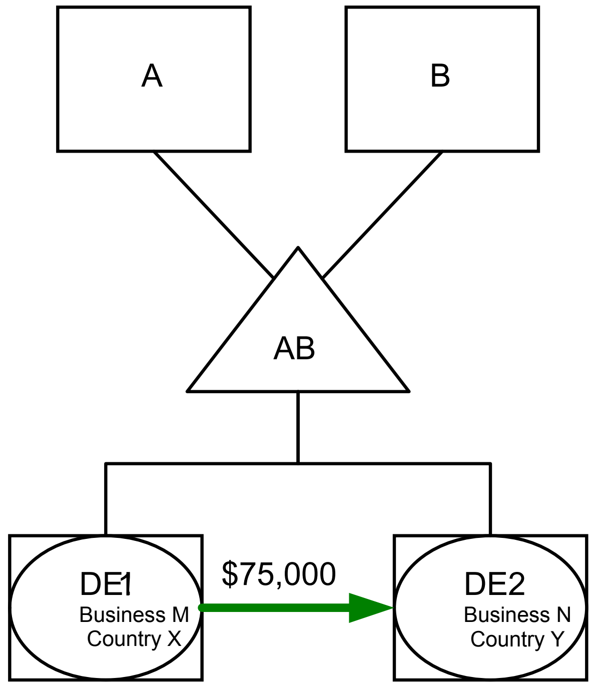
Partnership Allocation Splitters

Background

Prior to the enactment of Section 909, the regulations under Section 704(b) already addressed certain transactions designed to separate CFTEs from the income to which they relate. Treas. Reg. § 1.704-1(b)(4)(viii)(a) provides that any allocation of CFTEs does not have substantial economic effect, and therefore CFTEs must be allocated in accordance with the partners' interests in the partnership. An allocation of a CFTE is deemed to be in accordance with the partners' interests in the partnership if, *inter alia*, the CFTE is allocated in proportion to the distributive shares of income to which the CFTE relates. This rule effectively prohibits special allocations of CFTEs that separate the CFTEs from the related income but that would otherwise meet the requirements of the substantial economic effect rule.

Prior to amendment by the Section 704(b) Regulations, regulations under Section 704(b) also provided a special rule for payments between branches of a partnership, or between a branch of a partnership and the partnership itself, where such a payment gives rise to taxable income in a foreign country. Treas. Reg. § 1.704-1(b)(4)(viii)(d)(3). The regulations provided that the CFTE imposed on the payment is allocated to the CFTE category that includes the items attributable to the activities of the branch that receives the payment. Since the payment would typically be disregarded for U.S. tax purposes, the income related to the payment could be viewed as remaining with the payor branch, while the CFTE related to the payment would be attributed to the payee branch. Depending on the how transactions between branches are addressed in the allocation provisions of the partnership agreement, this rule arguably has the potential to separate the CFTE from the income to which it relates.

Example 24 of Treas. Reg. § 1.704-1(b)(5) illustrates the application of the special rule for inter-branch payments. In the example, A and B form AB, an entity treated as a partnership for U.S. tax purposes. AB owns 100 percent of the interests in two disregarded entities, DE1 and DE2, which respectively operate Business M in country X and Business N in country Y. DE1 makes a payment of $75,000 to DE2 that is deductible by DE1 in Country X and is treated as taxable income of DE2 in Country Y. See illustration below.



Prior to the payment, DE1 had $100,000 income and DE2 had $50,000. Taking into account the payment to DE2, DE1 has $25,000 in taxable income and pays $10,000 in Country X income taxes at a 40 percent rate. DE2 has $125,000 in taxable income and pays $25,000 in Country Y income taxes at a 20 percent rate. Because the payment from DE1 to DE2 is disregarded for U.S. tax purposes, however, $100,000 of the income of AB is attributable to the activities of DE1, while the remaining $50,000 of partnership income is attributable to the activities of DE2.

As originally promulgated, Example 24 considered three alternative approaches for allocating the income and CFTEs under the partnership agreement. In the first alternative, the income and CFTEs from Business M were allocated 75 percent to A and 25 percent to B, while the income and CFTEs from Business N were allocated 50 percent to A and 50 percent to B. According to the example, the $10,000 in Country X taxes were related to the $100,000 in Business M income, while the entire amount of $25,000 in Country Y taxes was related to the $50,000 in Business N income. Because the CFTEs were allocated in the same proportion as the distributive shares of income to which they were considered to relate, the example concluded that the allocations of CFTEs were deemed to be in accordance with the partners' interests in the partnership.

In the second alternative, the facts were the same as in the first alternative except that the partnership agreement allocated the $15,000 in CFTEs related to the Country Y taxes imposed on the inter-branch payment 75 percent to A and 25 percent to B. Since that was not the ratio used to allocate the Business N income, the example concludes that the allocation of Country Y tax was not in accordance with the partners' interests in the partnership unless the taxpayer could substantiate that the $15,000 in Country Y tax imposed on the inter-branch payment relates to income recognized by DE1 for U.S. tax purposes.

Similarly, in the third alternative, the partnership agreement allocated the $75,000 in Business M income attributable to the inter-branch payment 50 percent to A and 50 percent to B. The example once again concluded that the allocation of Country X tax was not in accordance with the partners' interests in the partnership unless the taxpayer could substantiate that the $10,000 in Country X tax relates entirely to the $25,000 in Country M income shared in the same 75/25 proportion as the $10,000 of taxes. Many existing partnership agreements that allocate income and tax expense on a geographic basis have relied on this third alternative to conclude that their allocation of CFTEs is in accordance with the partners' interests in the partnership.

While Example 24, as originally promulgated, was somewhat difficult to follow in places, the outcome of the second and third alternatives, at least, managed to allocate the CFTEs in the same proportions as the income upon which the taxes were imposed. The first alternative purported to allocate the CFTEs in the same proportion as the distributive shares of income to which they were considered to relate, but many observers noted that this first alternative arguably involved a separation of the earnings associated with the $75,000 inter-branch payment and the Country Y taxes imposed on that payment.

The Treasury Department and the Service made a similar observation in the Notice, that an allocation of income and CFTEs that met the requirements of Section 704(b) might nevertheless result in a separation of CFTEs from the related income for purposes of Section 909. The Notice nevertheless provided that a partnership allocation that satisfied the requirements of Section 704(b) and the regulations thereunder would not constitute a pre-2011 splitter arrangement for Section 909 purposes (unless the transaction was otherwise described as a splitter arrangement in the Notice). In the Notice, however, Treasury and the Service announced their intention to promulgate additional guidance under which an allocation described in Treas. Reg. § 1.704-1(b)(4)(viii)(d)(3) relating to inter-branch payments would be treated as a splitter arrangement in post-2010 taxable years if the CFTEs were allocated to a partner different from the partner to which the related income was allocated.

As promised, the Section 704(b) Regulations address the concern with partnership splitter arrangements by (1) deleting the special rule in section 1.704-1(b)(4)(viii)(d)(3) for inter-branch payments, (2) amending Example 24 to eliminate the potential splitting of CFTEs from the related income, and (3) promulgating rules treating certain partnership allocations of CFTEs as splitter arrangements for purposes of Section 909.

By eliminating the exception in Treas. Reg. § 1.704-1(b)(4)(viii)(d)(3) for inter-branch payments, the Section 704(b) Regulations now contemplate the that general principles of Treas. Reg. § 1.909.6T will apply such that CFTEs imposed on an inter-branch payment will be allocated to the CFTE category that includes the related income. There will therefore not be any foreign tax credit splitting event if the CFTEs and the related income are allocated to the partners in the same ratios. If the foreign tax paid or accrued by the partnership with respect to an inter-branch payment is not allocated to the partners in the same proportion as the distributive shares of income in the CFTE category to which the tax on the inter-branch payment is assigned, then the transaction is considered a splitter arrangement for purposes of Section 909.

Example 24 has been revised accordingly. The example now considers only two alternatives for the allocations in the partnership agreement. The first alternative allocates all partnership items from Business M, *except the Business M CFTEs*, 75 percent to A and 25 percent to B; all partnership items from Business N, *except the Business N CFTEs*, are allocated 50 percent to A and 50 percent to B. The inter-branch payment of $75,000 continues to be disregarded for this purpose. The example assigns the $10,000 in Country X taxes to the Business M CFTE category. The $15,000 in Country Y taxes imposed on the inter-branch payment is also assigned to the Country M CFTE category, since the related income of $75,000 that Country Y is taxing is in the Business M CFTE category. The remaining $10,000 in Country Y taxes imposed on the income of Business N is assigned to the Business N CFTE category. If, the example concludes, the partnership agreement allocates the $10,000 in Country X taxes and the $15,000 in Country Y taxes imposed on the inter-branch payment 75 percent to A and 25 percent to B, and the $10,000 in Country Y taxes 50 percent to A and 50 percent to B, then the allocations will be deemed to be in accordance with the partners' interests in the partnership.

The second alternative allocates the $75,000 in Business M income attributable to the inter-branch payment 50 percent to A and 50 percent to B. The $75,000 is treated as derived in an activity separate from the rest of Business M and, since it is allocated in the same proportion as the Business N activity, it is included in the Business N CFTE category. The Business M CFTE category includes the $25,000 in Business M income remaining after excluding the inter-branch payment and the $10,000 in Country X taxes imposed on the Business M income. The Business N CFTE category includes the $75,000 inter-branch payment, the $50,000 in Business N income, and the $25,000 in Country Y taxes imposed on the inter-branch payment and the Business N income. The allocation of CFTEs will be in accordance with the partners' interests in the partnership if the $10,000 in Country X taxes are allocated 75 percent to A and 25 percent to B, and the $25,000 in Country Y taxes are allocated 50 percent to A and 50 percent to B.

Both alternatives in the revised Example 24 are designed to ensure that the earnings and CFTEs associated with the inter-branch payment are allocated in the same proportions and thus do not result in a splitting of the taxes from the related income. The first alternative continues to disregard the inter-branch payment and leaves the income and taxes related to the payment in the CFTE category of the payor. The second alternative effectively acknowledges the existence of the inter-branch payment for partnership allocation purposes, and puts the income and taxes related to the payment in the CFTE category of the payee. Partnership agreements that allocate income and tax expense on a geographic basis typically should be able to rely on this second alternative to conclude that their allocation of CFTEs is in accordance with the partners' interests in the partnership.

Taxes Paid or Accrued in Taxable Years Beginning Before January 1, 2011

For taxes paid or accrued in pre-2011 taxable years, the rules of former Treas. Reg. § 1.704-1(b), described in detail above, will continue to apply. For pre-2011 taxable years, a partnership allocation that satisfies the requirements of Section 704(b) and the regulations thereunder in effect for such years will not constitute a pre-2011 splitter arrangement under the Section 909 Regulations.

Taxes Paid or Accrued in Taxable Years Beginning After December 31, 2010 and Before January 1, 2012 and Taxes Paid or Accrued in Taxable Years Beginning After December 31, 2011, Where Such Taxes Arise From Partnership Income Derived From Partnerships Whose Agreements Were Entered Into Prior to February 14, 2012

For taxable years beginning after December 31, 2010 and before January 1, 2012, taxpayers are subject to the pre-amendment Section 704(b) regulations, and CFTE allocations in accordance with the original Example 24 would be permitted.

However, although the changes to the regulations under Section 704(b) are not effective for taxable years beginning before January 1, 2012, foreign income taxes paid or accrued in a taxable year beginning after December 31, 2010 and before January 1, 2012 in connection with an inter-branch payment are nevertheless considered split taxes under the Section 909 Regulations, if the amount of the such taxes allocated to a partner differs from the amount that would have been allocated to the partner had they been allocated in the same proportion as the allocation of distributive shares of income in the CFTE category to which the tax would be assigned without regard to the special rule of Treas. Reg. § 1.704-1(b)(4)(viii)(d)(3).

There is a transition rule which further delays application of the Section 704(b) Regulations to partnerships whose agreements were entered into prior to February 14, 2012. The transition rule applies to a partnership for any taxable year if: (i) there has been no material modification to the agreement on or after February 14, 2012, and (ii) the parties do not have the power to amend the partnership agreement without the consent of any unrelated party in that taxable year and did not have such power in any prior year. Partnerships eligible for this transition rule will still be subject to the Section 909 Regulations in connection with an inter-branch payment for tax years beginning after December 31, 2010, and taxes will be subject to suspension, if the amount of the taxes allocated to a partner differs from the amount that would have been allocated to the partner had it been allocated in the same proportion as the distributive shares of income in the CFTE category to which the taxes would be assigned have been allocated.

Taxes Paid or Accrued in Taxable Years Beginning After December 31, 2011, Except for Such Taxes Arising from Partnership Income Derived from Partnerships Whose Agreements Were Entered Into Prior to February 14, 2012

The updated rules of the Section 704(b) Regulations generally apply for taxable years beginning on or after January 1, 2012. As noted above, however, there is a transition rule under which the Section 704(b) Regulations allocation rules do not, for any taxable year, apply in respect to partnership agreements entered into prior to February 14, 2012, where there has been no material modification to the agreement on or after February 14, 2012 and the parties do not have the power to amend the partnership agreement without the consent of any unrelated party in that taxable year and did not have such power in any prior year.

The Section 909 Regulations will also apply to suspend foreign taxes in connection with interbranch payments, to the extent that the amount of the such taxes allocated to a partner differs from the amount that would have been allocated to the partner had they been allocated in the same proportion as the distributive shares of income in the CFTE category to which the tax would be assigned have been allocated. However, partnership allocations that comply with the Section 704(b) Regulations should not be subject to suspension under Section 909.

Deductible Disregarded Payments

The Section 909 Regulations add a new anti-abuse rule. This new rule includes in the definition of “split taxes” any taxes paid or accrued in tax years beginning on or after January 1, 2011 with respect to a disregarded payment that is deductible by the payor of the disregarded payment under the laws of the foreign jurisdiction in which the payor of the disregarded payment is subject to tax on related income from a splitter arrangement.

Because there must be a splitter arrangement in place for this rule to apply, it does not create a new category of splitter arrangement. Instead, the rule treats as “split taxes” taxes that the Section 909 Regulations might not otherwise treat as split taxes when, because of a disregarded deductible payment, a tax that may not otherwise be treated as a split tax effectively substitutes for one that clearly would be treated as a split tax.

Consider, for example, a U.S. shareholder with a French corporate subsidiary, FranceCo. Assume that FranceCo owns all the stock in a U.K. subsidiary, UKSub, disregarded for U.K. and French tax purposes as separate from its owner but regarded for U.S. tax purposes as a corporation. Assume further that FranceCo owns all the stock in a German subsidiary, GermanyCo, treated as a corporation for French and German purposes but as a disregarded entity for U.S. purposes. In the same year UKSub earns 100 of income and FranceCo pays 100 of interest to GermanyCo. The above describes the only items of income and expense derived by the three non-U.S. companies.

Since UKSub is disregarded for UK purposes, the U.K. does not tax UKSub on its 100 of income, and, since its owner, FranceCo, is not a resident of the U.K., the U.K. does not tax FranceCo. on the income either. Assume that the tax rate in both France and Germany is 30 percent. Since France treats UKSub as transparent and FranceCo, its owner, is a French resident, France would impose 30 of tax on UKSub’s income but for the fact that FranceCo incurs 100 of offsetting interest expense. Accordingly, France does not impose any tax on FranceCo. GermanyCo imposes 30 of tax on the interest received by GermanyCo.

Under the Section 909 Regulations, any tax paid by FranceCo (here, the French tax) with regard to the income of UKSub would be subject to the suspension and recapture provisions of Section 909 because the tax would arise from a reverse hybrid splitter arrangement: France imposes tax on UKSub’s income, the United States treats UKSub as a corporation, and France disregards UKSub’s existence as separate from its owner’s. Absent the anti-abuse rule, however, FranceCo might argue that GermanyCo’s German tax does not arise from the reverse hybrid splitter arrangement but simply from GermanyCo’s taking into account of interest paid by FranceCo. Since the tax does not appear to arise from any other splitter arrangement, Section 909 would not apply.

Under the anti-abuse rule the German taxes paid with respect to the disregarded interest payment are treated as split taxes. This rule is limited to the amount of the disregarded deductible payment equal to the amount of related income from the splitter arrangement. Thus, if the interest payment from FranceCo to GermanyCo were larger than the amount of UKSub income to which the U.K. taxes applied, the German tax on the excess amount would not be considered a split tax.

This new rule is retroactive to taxable years beginning after December 31, 2010. The Service has indicated that it has the regulatory authority to provide this effective date because the Section 909 Regulations were issued within 18 months of the date of enactment of Section 909 and because the rule is an anti-abuse provision.

Rules Relating to the Operation of Section 909

As discussed above, the Notice addressed the application of Section 909 with respect to foreign taxes paid or accrued by Section 902 corporations in pre-2011 taxable years. In addition to identifying four categories of splitter arrangements which could give rise to split taxes subject to suspension for Section 902 corporations in pre-2011 years, the Notice also provided definitions and technical rules to assist taxpayers in applying Section 909 to these arrangements. The Section 909 Regulations adopt substantially all of the technical rules set forth in the Notice, with some additions and modifications.

Taxes Paid or Accrued in Taxable Years Beginning Before January 1, 2011

Foreign Taxes Paid or Accrued by Persons That Are Not Section 902 Corporations and "Qualifying Pre-2011 Taxes" Paid by Section 902 Corporations. The Section 909 Regulations do not require suspension of these categories of pre-2011 taxes, even if they would otherwise fall within the definition of a splitter arrangement described in the regulations. Thus, the technical rules for applying the Section 909 Regulations are not relevant to these categories of taxes.

Foreign Taxes Paid or Accrued by Section 902 Corporations That are Not "Qualifying Pre-2011 Taxes." The Section 909 Regulations address when and how Section 909 will apply to pre-2011 taxes paid or accrued by a section 902 corporation that are not qualifying pre-2011 taxes. The Section 909 Regulations follow the guidance in the Notice by limiting the application of Section 909 to four categories of pre-2011 splitter arrangements entered into by Section 902 corporations: (i) reverse hybrid splitter arrangements; (ii) foreign consolidated group splitter arrangements; (iii) group relief or other loss-sharing regime splitter arrangements; and (iv) hybrid instrument splitter arrangements.

<u>General Rules For Split Taxes And Related Income</u>. Like the Notice, the Section 909 Regulations require an annual determination – with respect to each pre-2011 splitter arrangement – of related income (or E&P), income of the covered person not consisting of related income, pre-2011 split taxes, other taxes of the Section 902 corporation not consisting of pre-2011 split taxes and the portion of these amounts that were distributed, deemed paid, included under Section 951, or "otherwise transferred or eliminated." Annual amounts of related income and pre-2011 split taxes are aggregated for each pre-2011 splitter arrangement and must be classified on the bases of foreign tax credit limitation basket, each covered person, and any successor to the Section 902 corporation as the payor of taxes or to the covered person as the earner of the related income.

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Rules Regarding Related Income. For reverse hybrid and foreign consolidated group pre-2011 splitter arrangements, a covered person's aggregate amount of related income must be adjusted each year by the net amount of income and expense attributable to the covered person's activities that give rise to income included in the foreign tax base, even when the net amount is negative. Since the Section 902 corporation or the Section 902 shareholder must take into account a positive amount of related income for the tax to be recaptured, a negative amount of related income would defer recapture. On the other hand, an inclusion of the entire related income account could result in the recapture of all suspended taxes, even if it is much smaller than the original tax base.

If a covered person's E&P includes related income and income that does not constitute related income, distributions, deemed distributions, and inclusions out of the covered person's E&P are considered to be made out of related income and other income on a pro rata basis. However, like the Notice, the Section 909 Regulations permit Section 902 shareholders to elect to treat distributions, deemed distributions, and inclusions as attributable first to related income (the "Alternative Method"). A Section 902 shareholder that elects this method must consistently apply it to all pre-2011 splitter arrangements. As discussed in greater detail below, the Alternative Method is not available for foreign taxes paid or accrued in post-2010 taxable years.

Related income retains its character when it is distributed, deemed distributed, or included under Section 951 and carries over as related income in the same manner that E&P carries over to a successor of a covered person under Section 381 or similar rules.

Related income is considered taken into account to the extent distributed, deemed distributed, or included under Section 951 out of the covered person's E&P and thereby included in (i) gross income by the Section 902 shareholder or a member of its U.S. consolidated group or (ii) E&P by the Section 902 corporation.

Rules Regarding Pre-2011 Split Taxes. The treatment of pre-2011 taxes parallels the treatment of related income. That is, where a Section 902 corporation has both pre-2011 split taxes and other taxes, foreign taxes deemed paid under Section 902 or Section 960 are treated as attributable to pre-2011 split taxes and other taxes on a pro rata basis. Pre-2011 split taxes deemed paid in connection with distributions from lower-tier foreign corporations to upper-tier foreign corporations retain their character as pre-2011 split taxes. Likewise, pre-2011 split taxes that carryover to another foreign corporation under section 381 or similar rules retain their character as pre-2011 split taxes. As related income is take into account by the Section 902 corporation or the Section 902 shareholder, a pro rata portion of the pre-2011 split taxes are no longer treated as split foreign taxes and, in the case of a Section 902 corporation, is reinstated in the relevant tax pool.

Partnerships, S Corporations and Trusts. Section 909 applies at the partner or interest-holder level. That is, taxes paid or accrued by a partnership, S corporation, estate or trust are treated as pre-2011 split taxes to the extent the taxes (i) are allocated to a partner or interest-holder that is a Section 902 corporation, and (ii) would be pre-2011 split taxes if the Section 902 corporation had directly paid or accrued the taxes on the date such taxes are taken into account by the partner under Sections 702 and 706(a), by the shareholder under Section 1373(a), or by the beneficiary under Section 901(b)(5). The same rules will apply for purposes of determining whether related income is taken into

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account by the a covered person. Any taxes split under these rules will be suspended in the hands of the partner, shareholder or beneficiary.

<u>Corporations that Become Section 902 Corporations</u>. Under section 902(c)(6), E&P and associated foreign income taxes paid or accrued by a foreign corporation in taxable years before it becomes a Section 902 corporation are treated as pre-1987 accumulated profits and pre-1987 accumulated foreign income taxes. The Section 909 Regulations fortunately provide that foreign corporations that become Section 902 corporations must account for split taxes paid or accrued and related income in pre-acquisition taxable years beginning only on or after January 1, 2012. Suspension of split taxes paid or accrued with respect to deemed pre-1987 accumulated profits attributable to earlier taxable years is not required.

<u>Coordination Rules – Section 904(c)</u>. Section 909 does not apply to excess foreign income taxes that were paid or accrued in pre-2011 taxable years and carried forward and deemed paid or accrued under section 904(c) in a post-2010 taxable year.

<u>Coordination Rules – Section 905(a)</u>. For purposes of determining in post-2010 taxable years the allowable Section 164(a) deduction for foreign income taxes, the carryover of excess foreign income taxes under Section 904(c), and the extended period for claiming a credit or refund, foreign income taxes subject to Section 909 are first taken into account and treated as paid or accrued in the year in which the related income is taken into account, and not in the earlier year to which the tax relates (determined without regard to Section 909).

Taxes Paid or Accrued in Taxable Years Beginning After December 31, 2010

Generally, the technical rules described in detail above are also applicable by analogy to all taxpayers in post-2010 taxable years. The preamble to the Section 909 Regulations states that Service expects to issue additional regulations that provide further guidance on determining the amount of related income and split taxes attributable to a foreign tax credit splitting event and additional guidance on the interaction between Section 909 and other Code provisions such as Sections 904(c), 905(a), and 905(c). Until such additional guidance is issued, the rules described above (most of which track the rules provided in the Notice) will be applied. The Alternative Method for attributing distributions, deemed distributions, and inclusions first to related income, however, is not available for post-2010 related income and split taxes.

Tax Treatment of Splitter Arrangements under the Regulations under Sections 704(b), 901, and 909

Relevant Time Period	*Taxes Paid or Accrued in Taxable Years Beginning Before January 1, 2011*	*Taxes Paid or Accrued in Taxable Years Beginning on or Before February 14, 2012*	*Taxes Paid or Accrued in Taxable Years Beginning After December 31, 2010 and Before January 1, 2012*	*Taxes Paid or Accrued in Taxable Years Beginning After December 31, 2010 and on or Before February 14, 2012*	*Taxes Paid or Accrued in Taxable Years Beginning After December 31, 2011*	*Taxes Paid or Accrued in Taxable Years Beginning After February 14, 2012*
Splitter Arrangement						
Combined Group Splitters	For payors other than Section 902 corporation payors and for Section 902 corporation taxes that are qualifying pre-2011 taxes, unmodified technical taxpayer rules apply. For Section 902 corporation taxes that are not qualifying pre-2011 taxes, Section 909 splitter regime applies.			Taxpayers may choose between (a) allocation under revised technical taxpayer rules, or (b) application of Section 909 splitter regime.		Taxpayers must allocate under revised technical taxpayer rules. Section 909 Regulation splitter regime should not apply.
Taxable Year Splitters Involving Hybrids		Unmodified technical taxpayer rules apply.				Revised technical taxpayer rules apply.
Reverse Hybrid Splitters	For payors other than Section 902 corporation payors and for Section 902 corporation taxes that are qualifying pre-2011 taxes, unmodified technical taxpayer rules apply. For Section 902 corporation taxes that are not qualifying pre-2011 taxes, Section 909 splitter regime applies.		Section 909 splitter regime applies.		Section 909 splitter regime applies.	
Hybrid Instrument Splitters	For payors other than Section 902 corporation payors and for Section 902 corporation taxes that are qualifying pre-2011 taxes, unmodified technical taxpayer rule apply. For Section 902 corporation taxes that are not qualifying pre-2011 taxes, Section 909 splitter regime applies.		Section 909 splitter regime applies.		Section 909 splitter regime applies.	
Group Relief/Loss-Sharing Splitters	For payors other than Section 902 corporation payors and for Section 902 corporation taxes that are qualifying pre-2011 taxes, unmodified technical taxpayer rule apply. For Section 902 corporation taxes that are not qualifying pre-2011 taxes, Section 909 splitter regime applies.		Section 909 splitter regime applies.		Section 909 splitter regime (as expanded by Section 909 Regulations) applies.	
Partnership Allocation Splitters	Unmodified partnership inter-branch payment allocation rule applies.		Unmodified partnership inter-branch payment allocation rule applies, but Section 909 splitter regime applies to taxes not allocated in the same fashion as the related income.		If taxes arise from partnership income derived from certain partnerships whose agreement was entered into prior to February 14, 2012, unmodified partnership allocation rule for inter-branch payment applies, but Section 909 splitter regime applies to taxes not allocated in the same fashion as the related income. In all other cases revised partnership allocation rule applies and Section 909 Regulation splitter regime should not apply.	